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FCC PRICE CAP PROCEEDING

HEARING

BEFORE THE

SUBCOMMITTEE ON COMMUNICATIONS

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

FCC PRICE CAP PROCEEDING

MARCH 1, 1989

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FCC PRICE CAP PROCEEDING

WEDNESDAY, MARCH 1, 1989

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
SUBCOMMITTEE ON COMMUNICATIONS,
Washington, DC.

The Subcommittee met, pursuant to notice at 9:00 a.m., in room SR-253, Russell Senate Office Building, Hon. Daniel K. Inouye (chairman of the subcommittee) presiding.

Staff members assigned to this hearing: Tom Cohen and John Windhausen, staff counsels; and Gina Keeney, minority staff counsel.

OPENING STATEMENT BY SENATOR INOUYE

Senator INOUYE. Since August of 1987 the FCC has been considering a proposal to change the way it regulates dominant common carriers. The Commission wishes to move away from rate-of-return regulation and adopt the so-called price cap approach.

Because this proceeding addresses issues of fundamental importance and because of the potential effects on ratepayers and shareholders, this Subcommittee held a lengthy hearing last August on this proposal, a hearing I should note where for the first time in my tenure as Chairman, every member of the Subcommittee as well as the Chairman and ranking member of the full committee attended. That is a testament to both the importance of this matter and our concern about the Commission's direction.

After considering the testimony at that hearing and meeting with many of the parties participating in this proceeding, I concluded that there were a sufficient number of key issues outstanding and that further deliberations were required and that hasty action would serve no one.

I, therefore, wrote the Chairman of the FCC in late September and requested first that the Commission revise its proposal to address the many concerns that had been raised at the Subcommittee's hearing as well as any comments filed with the Commission; second, that the Commission accompany this new proposal with a model demonstrating, its effects on ratepayers and shareholders; and third, that both of these items be put out for public comment so as to better ensure that this proposal would best serve the public interest.

The Chairman replied to me some three and a half weeks later stating that, "The Commission is reviewing all the comments on the further notice of proposed rule making and may well decide it

has sufficient information on which to act on the price cap proposal. In other words, the Chairman rejected the request.

Since then, the Chairman has tried to have the Commission adopt the price cap proposal. Late on Friday, the 27th of January, three days prior to a Commission vote on the proposal, the Chairman, however, decided to withhold voting until March 16th and give the Congress time to review its most recent proposal. He has since submitted his proposal and many pages of documentation to the Congress.

The purpose of today's hearing is to review this new proposal. Since the Chairman's proposal arrived here some 12 days ago, I have had my staff analyze it. I have also heard from numerous parties and, needless to say, there is much concern.

For example, does the proposal have a sound foundation? Does it strike the proper balance between ratepayers and shareholders? Is there evidence to support the conclusions? These and many other questions will be presented to the FCC Chairman this morning.

In addition, I encourage any party to submit views to the Subcommittee so that we can fully and carefully consider this matter.

Before turning to my fellow members for their statements, let me add one final thought. My September request of the Chairman was a relatively modest one. If he had complied and moved forward last fall, the Commission could have promptly aired this proposal and would now be in a position to make a decision based upon complete deliberations. Instead, we are asked by the Chairman to have this further review in an unusual and restricted manner, and I believe this is most unfortunate. I would hope that the Commission would proceed more constructively in the future.

May I now call upon Mr. Packwood. Senator, if you have any comments to make.

OPENING STATEMENT BY SENATOR PACKWOOD

Senator PACKWOOD. Only the following, and maybe the FCC Chairman wants to comment. It seems to me your price caps are not unlike—to the extent there is competition anyway—the so-called DRGs that we put into effect in the Medicare reimbursement business about five years ago.

We used to reimburse the hospitals prior to DRGs. It is a diagnostic research group. We used to reimburse them on the basis of cost and if an appendicitis operation cost a thousand dollars, we reimbursed them a thousand dollars plus a factor to help them on capital improvements and whatnot.

We found there is no incentive given that for restraining cost, and the Medicare reimbursements were just going out of sight. For us they are still high, but we brought them down by changing to the DRG system where we said henceforth, we are going to pay you a fixed amount for an operation. If you can make money on it, you can keep the money. If you cannot make money, you have to eat it, but we are not going to pay you any more than that.

In essence, it was a price cap. But, clearly there is competition among hospitals. Anybody other than rural hospitals in small towns, but anybody who thinks that in major hospitals or even rea-

sonably semi-urban centers there is not competition, they have not been reading ads or looking at what hospitals are doing.

I do not know, Mr. Chairman, whether your price cap is analogous, but it seems to me it is perhaps a better way of restraining cost and simply saying we will pay you whatever your cost is, whatever it is, plus a guarantee on top of that. Thank you, Mr. Chairman.

Senator INOUYE. Senator Pressler, do you have any opening remarks?

OPENING STATEMENT BY SENATOR PRESSLER

Senator PRESSLER. Mr. Chairman, thank you for scheduling this timely hearing on the Federal Communications Commission's price cap proposal. It is a subject of great interest to me.

As you know, I share your concern over the importance of maintaining geographic rate averaging. This issue was of great concern to ratepayers not only in Hawaii, but in South Dakota and all other states with rural and sparsely populated areas.

Having experienced the negative effects of deregulation of the airline, railroad and trucking industries in rural America, it is understandable that we view with trepidation any attempt to change telecommunications regulations. In other words, if it is not broke, do not fix it.

I think Chairman Patrick believes that current rate-of-return regulation works, but he seems to think that price caps will work better—benefitting both the consumer and the phone companies which would be subject to it.

I have discussed this issue at length with the telephone companies which serve South Dakota. Most of the state is served by small telephone companies and cooperatives, and therefore I have been extremely concerned about the effect of price caps on those companies and their customers. I remain concerned.

But as this issue has developed since our last hearing in August, Chairman Patrick has been very attentive to these concerns, and I believe he is sincere in his announced commitment to retain the small telephone company safeguards.

Not all the issues surrounding price cap regulations have been resolved, however, and I eagerly await Chairman Patrick's testimony regarding these issues.

Mr. Chairman, the Banking Committee is meeting this morning. I have to be present for a portion of that. I have a variety of questions. If I get back, I would like to ask them. Otherwise I ask unanimous consent that they be asked for the record.

Senator INOUYE. Without objection, so ordered.

Senator Burns, do you have any opening statement?

Senator BURNS. I have no opening statement at this time, Mr. Chairman. Thank you very much. And I shall be listening because I have got to be brought up to speed on this. I am new here. Thank you very much. I appreciate that.

Senator INOUYE. Senator Exon.

OPENING STATEMENT BY SENATOR EXON

Senator EXON. Thank you very much, Mr. Chairman. I want to compliment you for calling this hearing. I think this is a very important matter.

I want to echo the basic statements that have just been made by my friend and colleague from South Dakota with regard to the concerns of rural America, and I appreciate the fact that you have been more than forthcoming in at least considering this proposition.

Let me state that I am still open-minded on your proposal. I think it is a very innovative concept and some of the details as you have come forth with tend to allay some of my fears. However, I think the clear point should be made that obviously this is a controversial issue with long-range implications.

If we have learned anything from the savings and loan crisis or concept or morass or mess, call it what you will, we should learn that we had better take a long, hard look before we leap. Therefore, I am interested in your comments this morning, and I will have some questions as we proceed.

Thank you, Mr. Chairman.

Senator INOUYE. Thank you very much. I am certain that all of you have noted that I have been afflicted with an ailment most feared by politicians. I have laryngitis, bronchitis. So I will be submitting all of my questions, Mr. Chairman.

I have been instructed by my physician to keep quiet.

Which is not easy. So, with that and my apologies, may I call upon you, sir.

First, Senator Hollings, do you have a statement?

OPENING STATEMENT BY THE CHAIRMAN

The CHAIRMAN. Thank you Mr. Chairman. I congratulate you for again convening this subcommittee to address the FCC's price cap proposal. As you know, I have been visited often since this proceeding began by the telephone industry, all singing "Don't Worry, be Happy." I have also heard from the Wall Street crowd, going around whistling the theme from "Bonanza". And last August, we kept on hearing the FCC chairman sing "Forget Your Troubles, C'mon, Get Happy". Well, Mr. Chairman, after all of this, I am convinced, as a telephone ratepayer, that "I've Got Plenty of Nothing".

I have had problems since the FCC began its price cap proceeding, and I still have them today. Of course, I am skeptical of any plan under a Republican administration to expand deregulation. But this price cap plan has no relation to reality. The FCC has not produced any evidence that there is sufficient competition to justify this additional deregulation. The FCC says its plan will save consumers $700 million. But others say that the consumer will pay $400 million extra!

What troubles me most about this FCC concoction is that it is out of kilter from the beginning. If ratepayers find they are suffering, the FCC says "Well, we can take care of them when we review the plan in four years." But if the telephone industry feels the slightest pain, it can come in and seek relief immediately.

Now, I might not be bothered about this if I thought the FCC was going to do its job. But its record of reviewing industry rate requests over the past five years is miserable. This FCC just cannot be trusted to do its job. Let me review this sorry history.

In January 1986, the FCC ruled that the SNAFA contracts between AT&T and the Bell companies were not unreasonable, even though the FCC never looked at them. Then, in March 1988, the court of appeals threw out the FCC's decision and told the FCC it had to look at the contracts. The FCC waited nearly a full year after the court's ruling before ordering the contracts to be filed.

In November 1984 and April 1985, the commission approved new, higher "special access" rates even though they violated the terms of a contract between AT&T and the Bell companies. In April 1987, the appeals court again oveturned the FCC and ordered the commission to require the companies to refund the amount that they overcharged their customers. It has been nearly two years later, and the FCC has still not ordered the companies to make these refunds.

In April, 1987, the FCC found that AT&T's new tariff 12 raised substantial questions of lawfulness under the Communications Act. Nevertheless, the commission allowed the tariff to take effect subject to investigation. AT&T subsequently filed four more similar tariffs. The FCC found that all these tariffs raised the same questions, but it again let them take effect anyway. After almost two years, the FCC has not finished its investigation of any of these tariffs.

Last year, I wrote to you, Mr. Patrick, about the problems I had with your investigations of these tariffs. You wrote back to me stating that you would make your "best efforts" to finish your investigations by the end of last year, 1988. Well, it's now March 1st and not one of these investigations has been completed. If that was your best effort, I have little confidence in your "best effort" to protect consumers with price caps.

In short, the FCC simply cannot be trusted to protect consumers against higher telephone rates. The FCC treats the telephone industry like a loving grandmother—it can never say no. Under this price cap plan, consumers will get the worst of both worlds: If telephone costs go down, the telephone company keeps all the profits; if telephone costs go up, the consumer foots the bill. Whoever said that price caps was an example of "heads I win; tails you lose" was right on target.

Senator INOUYE. Mr. Patrick.

STATEMENT OF HON. DENNIS R. PATRICK, CHAIRMAN, FEDERAL COMMUNICATIONS COMMISSION, ACCOMPANIED BY JERRY BROCK, CHIEF, COMMON CARRIER BUREAU

Mr. PATRICK. Thank you, Mr. Chairman, and good morning. Good morning, members of the Subcommittee, as well. I do welcome this opportunity to discuss with you the FCC's efforts to improve its regulation of the telephone industry.

I believe that with the help of the various suggestions that have been made by this Subcommittee and other members of the Congress, the Commission has been able to craft a plan for AT&T and

a revised proposal for the local telephone companies that will provide greater incentives for carrier efficiency while properly balancing the interests of ratepayers and shareholders.

I have with me this morning Jerry Brock, who is chief of our common carrier bureau.

If I might, Mr. Chairman, I would like to read this statement. It is a tad longer than usual, but in light of the fact that this is my fifth appearance before the Congress with respect to rate caps and in light of the fact that there have been substantial changes that I believe are responsive to the concerns that have been expressed by many members of Congress, I wanted to highlight some of those changes up front as a basis for our discussion.

There is little dispute today that the telecommunications industry has become one of our nation's most critical infrastructure industries as we approach the 21st century. That is why the Commission has followed the lead of a number of states during the past few years in examining the possible implications of some form of incentive regulation for dominant interstate carriers.

The rate-of-return regulation system we use today is cost-plus contracting, pure and simple. We tell carriers they can charge rates that will cover their cost and earn about 12 percent on every dollar invested. We, therefore, create for the industry all the perverse incentives associated with cost-plus contracting.

As Senator Packwood pointed out earlier, having helped create these perverse incentives, we then spend at the Commission millions of dollars and many man-hours attempting to prevent carriers from acting in accordance with the incentives that we have really helped to create.

By changing just our tariffing procedures, and that is really all we are talking about here, our price cap proposal will replace these perverse incentives with pro-consumer efficiency enhancing incentives.

The idea is simple. We replace cost-plus regulation with price regulation. We give carriers a price ceiling, an aggressive mark that will ensure consumers share in the benefits up front. If they can beat that mark, they can keep some of the increased profits in the short run. Thus, even in the short term both the companies and consumers are better off.

This is not a zero sum game. That is an important point, I think. And in the long run, prices can be reduced even more dramatically as carriers improve their efficiency because, for the first time in the history of regulating these carriers, they will have an incentive to reveal to the Commission and, to the Congress just exactly how efficient they can be. They do not have that incentive today.

I suggested that we consider the possible benefits of price cap regulation in a speech more than two years ago. In August 1987 the Commission issued a lengthy notice of proposed rule making. We received more than 6,000 pages of comments and reply comments in response to that notice and a subsequent public notice seeking specific rule proposals for implementing price caps.

In response to the Congress we then issued a detailed further notice setting forth specific price cap proposals for AT&T and the LECs for implementation on April 1, 1989. In response to the further notice we received 5,000 additional pages of comments.

At the time the Commission votes on March 16th, Congress will have held five hearings on this proposal. The Commission will have provided more than 300 pages of written answers to questions from members of Congress and will have conducted numerous briefings of Congressional staff.

In the submissions provided to you these past six weeks I have provided, I think, an unprecedented amount of detail about what I am recommending to my fellow commissioners that we adopt as a final report and order, at least with respect to AT&T.

I cite this history of Congressional involvement not by way of complaint but by way of noting that there has been a great deal of interaction, and it has affected in a substantive way the proposals that are before the Commission or will be put before the Commission later this month.

I believe this constructive dialogue has helped us to craft a better proposal to improve our regulation of dominant carriers, and I welcome the opportunity to continue the dialogue.

As I have already noted, you have received extensive detail on my recommendation, but let me touch on a few of the highlights. First, I am recommending we decide that rate-of-return regulation should be replaced with incentive regulation for dominant carriers generally.

Second, I am recommending we adopt a specific plan for AT&T that would implement incentive regulation as of July 1, 1989 for a period of four years. That plan would cap AT&T's prices to require 3 percent reductions in real terms after adjustments for exogenous costs outside of AT&T's control.

Third, I am recommending that the FCC seek further comment as requested by the Congress on specific revisions to the current proposal for the local exchange carriers.

I think there is a particularly strong basis for applying incentive regulation to these companies eventually in that they are generally less subject to incentives created by competition and, therefore, the benefits are potentially higher.

The recommendation I am making to my fellow commissioners includes several specific changes in the plan set forth in our May 1988 further notice of proposed rule making or from that further notice. Many of these improvements result from the helpful suggestions made by you, Mr. Chairman, and other members of the Subcommittee. Let me summarize some of them.

Perhaps most importantly in order to protect consumers, especially residential and small business subscribers and competition, I now propose to group AT&T's services into three different baskets. These new baskets will help prevent AT&T from raising the prices paid by residential and small business consumers and by business for 800 service in order to institute price reductions for other more competitive services. In other words, it avoids cross-subsidies between the baskets. We have gone from two baskets to three baskets. That was a suggestion that resulted from my dialogue with the Congress. This change in baskets strengthens the protections enjoyed by residential and small business consumers and provides greater safeguards against possible predatory pricing.

I am also advocating that we protect residential consumers by establishing a separate constraint on the average rate paid by resi-

dential consumers for services contained in AT&T's residential service basket, a constraint that would place a 2 percent ceiling on the annual change in that rate relative to the annual change in the index for the entire basket. As explained in greater detail in my recent submissions to you, I am responding to concerns expressed by you, Mr. Chairman, and other members by recommending that we modify our proposal in order to provide greater assurances that small telephone companies, and the rural consumers that they serve, are not adversely affected by the implementation of incentive regulation.

In addition, in response to concerns expressed by you, Mr. Chairman, among others, I am proposing that we modify our LEC proposal to provide greater assurance that nothing in price cap regulation undermines the FCC's policy in support of geographically averaged rates.

Most importantly, I am recommending that we establish a separate common line basket with pricing rules that will place significant limits on possible carrier common line charge disparities that could increase pressure on inter-exchange carriers to deaverage their rates.

I also suggest that the Commission make clear it will suspend and investigate any AT&T proposal to geographically deaverage its toll rates, and I can assure you as well, Mr. Chairman, that nothing in my proposal will disturb the Commission's rate integration policy, which folds AT&T's domestic long-distance rates to and from Hawaii into its nationally averaged long-distance rate schedule. And I might make the same comment with respect to Alaska.

Another modification I plan to recommend that the Commission make in its proposal to implement this regulation for the LECs is to make participation in the cap program mandatory for the large companies. I am also recommending because of the possibility of variations in individual LEC productivity around the industry average that the FCC explore additional regulatory safeguards to ensure that LEC prices remain within the zone of reasonableness.

One such safeguard would be an automatic stabilizer based on LEC's achieved rate of return. Another possible response would be to accelerate our comprehensive performance review for the LECs. I believe we need further comment to permit an informed decision in the public interest on those proposals. And so we will have a further notice with respect to the LEC portion of this proposal.

In sum, it is critical that we institute an improved regulatory framework for our interstate telecommunications industry. Such a framework will benefit consumers and also spur this industry to fulfill its destiny as one of the most significant elements of our nation's infrastructure for the remainder of this century and the beginning of the next.

I believe that it is time to take the next step forward with the support of industry and labor. We should follow the example of the vast majority of states which have already moved away from traditional rate-of-return regulation over AT&T and implement incentive regulation for AT&T as of July 1989.

We should place out for further comment a specific incentive plan for the LECs which holds forth the promise of significant additional benefits for consumers and for this country.

I look forward to your suggestions and your questions. And, Mr. Chairman, if I might just respond to your earlier comments, I apologize for any misunderstanding with respect to the correspondence which you directed to me in September. At that time I did not feel that we were in a position to make substantive responses to the very important questions that you had raised because the docket that included now some 10,000 pages of materials had just closed, and we had not reviewed the docket as yet, and therefore were not in a position to respond.

I had my staff consult with your staff with respect to the fact that that information would be forthcoming as we analyzed it, and I hope and trust that we have made that information available to you now. I can say very specifically that the issues that you raised have been addressed, and the suggestions made by various members of Congress have resulted in substantive changes to the proposal that we have before us.

We also have, and I will be happy to explore with you, empirical data that you requested demonstrating that under our rate cap proposal consumers will be better off than they would be under rate of return. Thank you, Mr. Chairman, and I would be happy to answer any questions that you have here and later in written form for the record.

Senator INOUYE. Thank you very much. Senator Burns.

Senator BURNS. I have no questions at this time.

Senator INOUYE. Senator Exon?

Senator EXON. Mr. Chairman, thank you very much. Mr. Patrick, in view of the controversies that surround this issue, in your view is there anything wrong with the FCC not taking final action on your proposal until President Bush has had a chance to fill the two vacant Federal Communication seats on the Commission?

Mr. PATRICK. Well, senator, I think that that would be ill-advised, yes.

Senator EXON. Ill-advised to wait?

Mr. PATRICK. Ill-advised to wait.

Senator EXON. Why is that?

Mr. PATRICK. I will tell you why that is. In very simple and direct terms it is because I believe that we are today foregoing very substantial benefits for consumers and for the industry. I mean by that to refer to the fact that we have demonstrated and can demonstrate that consumers will be better off with the implementation of the price cap proposal than they would be under rate of return to the tune of about $900 million, just with the implementation of the AT&T piece. That was demonstrated in data that we have submitted.

But I also think it is extraordinarily important as a more generic matter to restructure the incentives that we give this industry. The telecommunications industry is in my opinion the single most important infrastructure industry in this country for business and for consumers as well. We have to begin to send messages to that industry that we want it to be more efficient, more innovative, et cetera. As far as I am concerned, the sooner we start on that the better.

Very briefly, the third reason is the Commission that now sits before the Congress, for better or for worse, is a Commission that

has spent over two years analyzing this record, and analyzing the potential benefits of price cap proposals.

It is the Commission that has responded to the Congress' concerns about various aspects of the proposal and made these modifications. I think it would be irresponsible of us, and of me as Chairman, not to put that issue to the Commissioners that have been studying it so long.

On the other hand, I manifestly have not rushed to judgment on this issue given the fact that it has been about two years since we first began to study the question.

Senator EXON. Well, therein lies the concern. I mean, since it has been going on and I can see the potential benefits for consumers and compliment you once again for the changes that you have made. Along that line though, as Chairman of the Commission have you had any indication whatsoever from the President or other administration officials as to when we might expect the nominations to fill the vacant seats?

Mr. PATRICK. I really have no detailed or inside, so to speak, information on that. It is my understanding that they are actively working on filling the two Commissioner vacancies that exist today, but I have no information with respect to any particular calendar, no, sir.

Senator EXON. Well, as a follow-up to that, let me ask you this question. The National Telecommunications & Information Administration in the Department of Commerce and others continue to study our overall telecommunications concerns very closely. Have you spoken with Mr. Mosbacher, the new Secretary of Commerce, or other people in the Bush Administration about your proposal, and if so do they support it, and if so, how actively?

Mr. PATRICK. The NTIA, the National Telecommunications & Information Administration, the part of the Department of Commerce which is directly responsible for communications issues, is highly supportive of this proposal and I have no reason to believe that that support has changed since the election.

Senator EXON. In my opening comments and in my start of questioning you today, I complimented you for being responsive to some of the concerns that have been expressed with regard to rural America. Could you just briefly outline for us some of the changes or alterations that were made in your original proposal to help allay those fears?

Mr. PATRICK. Senator, I can, with the caveat that I am not sure I can be real brief because we have made many changes to this proposal in response to concerns that were expressed by the small companies.

Senator EXON. Could you name the few important ones, in your view?

Mr. PATRICK. I will do that. Probably the single most important issue generically is the question of high cost support to small companies.

It was never our intention, and it was never the effect of price caps, to compromise in any way the subsidy mechanisms that we have in place for small companies, but at the time of our first proposal—notice of proposed rule-making—some of the companies expressed concern that that fact was not made explicit.

So one of the most important changes we have made to the item is to make explicit that price caps will in no way compromise any of the support mechanisms that we have in place to subsidize high-cost companies.

We also retain, and make explicit that we will retain, a rate of return prescription which is important for purposes of computing support for small companies. We also make the high-cost support that is paid by certain companies into a fund that goes to subsidize the small companies an exogenous cost factor, and all that means is that it is flowed through directly so that there will be no incentive for these companies to compromise that support because they can flow it through directly.

The small companies were interested in having an opportunity to elect on a voluntary basis whether or not to join price caps after depooling. We have provided for that opportunity.

Small companies were afraid that we were going to compromise our longstanding support for the concept of a unitary rate of return, and we have made explicit in this order that we do not believe that price caps should disturb our longstanding practice of using a unitary rate of return. They did not want to see us use a separate rate of return computation for various companies depending upon their cost of capital.

Most importantly, the matter of geographic rate averaging is very important to the small companies. Caps do not threaten geographic rate deaveraging. The mechanisms to reduce the difference in prices for, or cost of access among, the various companies will stay in place, and that of course has the effect of softening, or lessening, the incentive to de-average.

It is very complicated. I said that in a rather complex manner. The pressure to de-average, to the extent it exists, is a function of different costs for access in various areas. The way the Commission has dealt with that problem is to subsidize the high-cost companies so the difference is not as great. Those subsidy mechanisms will remain in place under caps. That is a very important point with respect to rate deaveraging.

But we go further than that in this order, and we provide explicitly that we are committed to the policy of rate averaging, and I am recommending to my Commissioners that they adopt an item which will for the first time say, and this was in response to the Chairman's concern on this exact issue, that we will suspend and investigate any tariff that proposes a rate deaveraging, and that is an important point as well.

Lastly, rate deaveraging. We have provided for in our price cap proposal a separate basket for nontraffic-sensitive costs. These are the fixed costs that are important in this whole issue. By having a separate basket we prevent cross-subsidies that again could compromise the level of support that the small companies enjoy.

All of that having been said, I would also indicate that I have met personally with representatives of small companies and we have explored these issues. It has resulted in these changes, and we received the other day a letter from OPASTCO indicating that they were satisfied and were supportive of price caps.

Senator EXON. Thank you, Mr. Patrick. Thank you, Mr. Chairman. I must leave for a very important meeting of the Budget

Committee with regard to the S&L situation. I may have some additional questions for the record.

Senator INOUYE. Thank you very much, sir. Senator Stevens.

Senator STEVENS. Thank you, Mr. Chairman. Chairman Patrick, I think that this is the finest example of Commission cooperation with the legislative oversight process that I have seen here in 20 years, and I congratulate you for this and also my staff advises me that the Communications Workers of America now supports the price caps concept, and that is significant support in view of their past reaction to the overall kind of concept.

Let me say this. I hope that you can push forward your review of the local exchange companies so that we might have implementation of price caps for them at the same time as AT&T, or very soon thereafter. Is that possible?

Mr. PATRICK. I think that it is important that we press forward with the proposal as it relates to the local exchange companies. Precisely because the local exchange companies are facing less competition, they are arguably facing less in the way of incentives to be efficient, to be innovative, to take those actions which will help consumers, and that is why I agree it is especially important that we press forward.

Yes, I think that we can do it. I am proposing what is in effect a further, further notice of proposed rule-making with respect to the local exchange companies because many in Congress have suggested that we take additional time. We are going to make some additional proposals that we think will address issues that are unique to the local exchange companies, but yes, in general I think we can and should press forward aggressively to adopt an incentive regulation plan for the LECs.

Senator STEVENS. In your statement, you suggest that the Commission make clear that it will suspend and investigate any AT&T proposal to geographically de-average rates. I take it that that suspension would last until the investigation was complete and there was some disclosure of the results of that investigation?

Mr. PATRICK. Our investigations do result in—well, first of all it is a public proceeding and it results in a document that is public, and of course the Commission could choose at the end of the suspension period simply to deny the tariff.

Senator STEVENS. Just to show you that I want to maintain my reputation of being very provincial, let me read to you part of your statement. It says: "I can assure you as well, Mr. Chairman, nothing in my price cap proposal should disturb the Commission's policy favoring integration of AT&T's domestic long-distance rates to and from Hawaii and its nationally-averaged long-distance rates."

Now, there happens to be an area of the country that is equally sensitive to that problem, and I wonder if you would like to comment upon how it might affect Alaska.

Mr. PATRICK. Well, Senator, I must say that as I was reading my opening statement I noted this glaring error in omission, and I can assure you that I will speak to the party that prepared my opening statement about it, and while you were out of the room I want you to know, because I am quick on my feet, I added Alaska in my reading of the opening oral statement.

Senator STEVENS. I am delighted to hear that. I was out of the room, but the Chairman and I did initiate the whole concept of Nation-wide rate integration, particularly with reference to our two states, and I am pleased to hear that.

Mr. PATRICK. Yes sir, I did add that, and let me say quite seriously that it will in no way jeopardize rate averaging or rate integration as it relates to either Alaska or Hawaii, and in fact I committed at the initiation of this inquiry to make sure that small companies in rural areas were no worse off, not adversely affected in any way by price caps, and in fact I believe strongly that they will be made better off.

Senator STEVENS. When you first came up with this concept I embraced it wholeheartedly, because I think areas such as ours will benefit substantially from the concept because it really would give us a chance to expand rapidly into areas that have no service and have the concepts of price caps go into effect, which the incentives there I think to extend service into underserved or unserved areas are overwhelming, and so I again want to congratulate you for taking up the whole concept. I have just two questions left.

One, you are going to make a recommendation to the Commission. Can you give us any time frame for action now by the Commission, and what are the pitfalls you see out there toward implementation of this policy as far as the Commission is concerned?

Mr. PATRICK. The timetable that I contemplate is putting a proposal before the Commission at our March 16th meeting. That would be a proposal with respect to a plan, for the adoption of a plan for AT&T but the adoption of a further, further notice of proposed rule-making with respect to the local exchange companies.

And I appreciate your comments earlier about attempts to accommodate and deal effectively with the oversight process, because what you have before you, and what your staffs have received, is what I think is unprecedented information in the sense that it represents my thoughts with respect to my thinking at this point, having reviewed the record, and my proposals—what I intend to propose to my fellow Commissioners.

And that is what you have before you, I raise that by saying that what we are discussing here today are my thoughts. I think there is generally support at the Commission for this proposal, but of course I will be consulting in the next several weeks with my fellow Commissioners with respect to various aspects of the details.

Senator STEVENS. Thank you very much. Mr. Chairman, Mr. Patrick's background includes being a surfer in California, and I just want you to know that I think that is a great qualification.

Thank you very much.

Senator INOUYE. Senator Gorton.

Senator GORTON. Thank you, Mr. Chairman. Mr. Patrick, as you realize, I come into this process rather tardily, having not been through the entire history which you describe, and so you will forgive me for asking a couple of relatively simple questions to see that I understand what you are proposing.

First, with respect to the order involving AT&T which you would like to have go into effect on July 1, 1989, I take it that you are doing this on a four-year—you propose this on a four-year experi-

mental basis rather than on a permanent basis so we can see how it works in practice. Is that what I get from your statement?

Mr. PATRICK. We will have ample opportunity to evaluate how this proposal is affecting AT&T in its performance. We do propose a four-year period of time for the initial evaluation. A generic top-to-bottom evaluation would begin after the third year, and we would look to adjust either the base prices or the formula itself based upon the data that we evaluate at that time.

But I might add, Senator, and I think it is an important point, there is some misimpression that the Commission is simply going to launch this program and then look at it four years hence, and that is not the case. We are retaining many reporting requirements so we will, on a year-to-year basis, have a great deal of information about the experience of AT&T with the price cap proposal, and if any anomalies were to develop we of course would take corrective action.

Senator GORTON. In any event, were you to take no action after four years, would rules automatically revert to what they are today? Is it required that the FCC take some action in order to continue this experiment after the four-year period?

Mr. PATRICK. I do not propose a sunset provision for these rules. I will propose that we adopt a price cap form of regulation for AT&T, and that we look to adjust it in the event that any adjustments are in order.

Senator GORTON. With respect to the regional Bell operating companies, I gather that your initial recommendation would have treated them not identically to AT&T, but would have established this rule of operation for them at the same time, but that you now find certain difficulties surrounding the fact that different of those companies have different degrees of efficiency or effectiveness and you need to deal with that before you implement the rule with respect to those companies. Is that what I understand?

Mr. PATRICK. That is correct, senator.

Senator GORTON. Could you describe that in a little bit of detail?

Mr. PATRICK. Yes, sir. Of course the productivity number that we project and utilize is an important part of the formula by which we bring down prices. In the case of AT&T it is easier to identify that number for a number of reasons, one of which we are dealing with one company instead of several and we are not dealing with companies that were affected in the very dramatic fashion that the regional BOCs were affected by divestiture.

You are absolutely correct that there is some record evidence of variability in productivity among the RBOCs post-divestiture. I might add that the long-term data that we have suggests that the historic productivity, annual productivity, improvement in productivity for both AT&T and the local exchange companies is somewhere between 2 and 2.5 percent better than the economy as a whole.

Post-divestiture, we have corroborated that evidence as to AT&T. But yes, you are correct that as to the LECs there is some record evidence of variability and for that reason, again to err on the safe side, we are proposing in this further notice, and one of the reasons we are doing a further notice is to get some more comment on what we call a stabilizer mechanism, which is a mechanism that

would correct any anomalies that might result from the fact that there is some evidence of variability among productivity.

If I might just add, whereas we are going to propose that, and we think it is appropriate to err on the safe side, I tend to discount the data that we have in that very short period of time post-divestiture. Obviously it was a time of radical change, and it is not clear to me that in fact the 2.5 number we are utilizing is not the correct number. But to err on the safe side we want to explore this concept of a stabilizer, so in the event any company was extraordinarily efficient, the stabilizer would catch that and correct for that circumstance.

Senator GORTON. Is there any chance that this change will benefit the least productive or the least advanced of those regional Bells?

Mr. PATRICK. I am not sure I know what you mean by benefit, although the stabilizer——

Senator GORTON. Protect them.

Mr. PATRICK. Well, yes sir. The stabilizer is basically a concept of correcting for a current rate of return that would exceed a certain limit or fall below a certain limit, and it is the latter that goes to your point, I think.

If for whatever reason a company could not earn enough to cover its cost, then that company of course has a legal right to increase its rates if it fell below the zone of reasonableness. There is not one number. There is a zone of reasonableness. If it fell—the earned return of that company fell—below the zone of reasonableness, the stabilizer would correct for that result as well, on a going-forward basis. At least that is the concept. This is a concept that we are putting out for further comment.

Senator GORTON. Thank you, Mr. Chairman.

Senator INOUYE. Thank you, sir. Senator McCain?

Senator MCCAIN. Thank you, Mr. Chairman. Mr. Patrick, as I understand it you are making this case obviously because it is for the benefit of the consumer. Is that right?

Mr. PATRICK. That is correct.

Senator MCCAIN. Why is it that apparently most consumers, most consumer organizations are opposed to price caps?

Mr. PATRICK. Well, Senator McCain, I would not purport to speak for any of the consumer groups that have commented on this, and so I could give you my observations only. I think that we have now reached a consensus in the comments that have been filed that rate of return regulation is not particularly effective. It is not particularly positive from the perspective of consumers. The debate has evolved into how we should provide for a formula that will best serve the interest of consumers and in fact balance the various interests that we are talking about.

So the debate really now focuses on how to do it. I think we have reached a consensus that there are misincentives that are created by rate of return regulation, and some gains to be made by improving the incentive structure that we have before us.

Senator MCCAIN. Mr. Patrick, you said it is clear that rate of return is not satisfactory to consumers yet. There are a lot of consumers that will make the case that rates have declined; that service has improved; that there is an increase in competition since the

break-up of AT&T, and indeed that things are satisfactory, and particularly in the overall cost to the consumer under the present system for the use of a telephone.

Mr. PATRICK. Yes, sir, and I am glad you raised that point. Because there is, you are quite right, a general reaction that things are pretty good. Rates in the telephone industry have been coming down. Why do we need to change things now?

There are several answers to that. The first is this, that one of the things that has driven rates down dramatically over the past several years is our so-called subscriber line-charge program, where we have reduced the cost of access for long-distance carriers, and then we flowed through those reductions in access charges to consumers.

That has driven a substantial amount of the price reduction for consumers in the last several years. That process comes to an end shortly, so we are not going to see any more price reductions driven by that.

Number two: when we say things are pretty good we have to ask ourselves, compared to what? Yes, the telecommunications industry has achieved a certain level of productivity that has exceeded the general economic, or general productivity in the economy. But we are convinced that the industry could do even better.

We know that the industry does not pursue as great a set of efficiencies as it could because rate of return regulation does not reward that activity. Indeed, if a carrier goes out and becomes too innovative, as a result of which it pumps up its rate of return over a certain level, the Commission will respond by adjusting its prices downward.

So we not only do not have a positive incentive with respect to efficiency but we can under certain circumstances punish it. So in comparison to what? I think that we can do better.

Yesterday on the House side, Congressman Ritter observed that given the fact that the telecommunications industry is so technology-intensive, he thinks the fact that we have observed a 2.5 percent productivity growth annually in the past several years is an abysmal record; that we should be able to do much, much better. Certainly we have done better in the computer industry. Well, part of the anomaly, part of the problem, I think, is rate of return regulation.

Answer number three, to the question why change—

This is a different world. Rate-of-return regulation is a relatively rigid regulatory approach which is ill-suited to a world that is becoming more and more competitive. You cannot have it both ways. You cannot introduce competition and then attempt to rigidly control the allocation of prices and the pricing process, and that is something we are driven to do in rate-of-return. So we need a certain amount of additional flexibility.

Secondly on that point, or a subpoint, and then I will quit: the cross-subsidy problem is one that becomes more pronounced as you introduce competition into this marketplace—that is, cross-subsidies from less competitive services to more competitive services or wholly deregulated services.

Rate-of-return regulation tends to encourage cross-subsidies precisely because you can get away with it. If you can convince the

Commission that you incurred a dollar over here that you really incurred over there, we will cover that cost under rate-of-return regulation.

Well, under a cap you can come to the Commission and you can say, I incurred the dollar here, when you really incurred it there, but it will not do you any good because you have still got the price capped, and so it will discourage the cross-subsidies, and that is a terribly important problem to be addressed in the future as competition continues to unfold.

Senator MCCAIN. It is my understanding that a carrier could increase its rates by 5 percent a year. That could be as much as 15 percent over a period of three years, obviously. What is the incentive not to raise rates where there is no competition, which is in significant parts of the country. What is the incentive for one of these companies not to raise their rates?

Mr. PATRICK. Well, that is a very important point. One of the reasons I think we have to go to price caps and move away from rate-of-return regulation is under rate-of-return regulation, you are quite right, competition tends to focus on the high end of the market, and customers in the rural areas and other areas that are not as subject to competition do not see price reductions. They do not see economies, efficiencies, et cetera.

With price cap regulation, you create positive efficiency-enhancing incentives across the board. To answer your question very specifically, the incentive is that even in an area where you are not facing competition, if you can beat the mark—if you can beat the formula that is set forth by the Commission in the price cap proposal—you can make some additional profit underneath the cap. It is the carrot.

So even if you are not facing competition, if you can get more efficient, if you can beat the 3 percent in real term reduction that the Commission has set as a target, you can keep a little bit of profit in the short run. In the long run, we will recoup that, just as takes place in the competitive marketplace, but in the short run you can make some of that—the company, that is.

The equalizing effect of price caps in terms of causing the efficiency-enhancing behavior to take place in all segments of the market is one of the principal benefits, I think, of price cap regulation.

Senator MCCAIN. Well, thank you very much Mr. Patrick. I am not sure what your surfing experience has to do with this issue, but we eagerly await the next earthquake when you may surf off the coast of Arizona.

Thank you, Mr. Chairman.

Senator INOUYE. Chairman Hollings.

The CHAIRMAN. Chairman Patrick, I do not know of the time that you really cut back the rates of telephone companies because they made too much money. The experience has been of the Committee that they play a game of filing much higher tariffs. These rates are then debated and investigated, all the time the company's making money. In the end, maybe a minor adjustment is made.

When major adjustments are attempted the companies appeal it. The Commission really does not have a record in the past 20 years

where carriers have been making too much money and then being cut back. Is that correct?

Mr. PATRICK. I am not sure I understand your question.

The CHAIRMAN. When they make too much money, the FCC comes in and cuts them back—cuts the rates so they do not have an incentive, really, for improved productivity and making more money. That is what you just attested to. When did that happen?

Mr. PATRICK. Well, as a matter of fact this goes to this question of—if I understand your question—it goes to the question of demonstrating that in fact there is gold-plating, that they are earning too much; that there are these incentives that have resulted in—misincentives that have resulted in prices that are too high.

We took a look at a distinct period of time in response to, it may have been your question, Senator, at one of our earlier hearings, and we found—and I am just recalling from the top of my head—about $163 million for some defined period of time, of costs that were disallowed by the Commission because they represented investment that was ill-advised, and $8 or $9 hundred million in access charges that were disallowed because we thought they were too high.

So there is evidence of padding out there. There is evidence that the incentives have not resulted in efficient behavior in all regards.

But the more important point I think is this, Senator: the reality is that with 2,000 people at the FCC we do not have the ability, and we will never have the ability—and you can triple the size of the agency and it still will not have the ability—to second-guess the investment decisions of the telephone industry that includes 1,400 telephone companies and $50 billion in annual interstate revenues.

One of the reasons for that—one reason is obviously the administrative reason. The second reason for that is the legal standard. I cannot set aside the investment decision of a company unless I can prove that the investment decision was "imprudent as a business matter when made". That is an extraordinarily difficult standard to meet, as a result of which we are effectively without the ability to set aside these investments.

So let us get incentives that cause them to make efficient decisions in the first instance.

The CHAIRMAN. Well, of course, I see it the other way, that if you put in a price cap they will have Open Sesame on investments. You have said now that if the cap was there, we will not even review the investments. You can make them as you wish. And you cannot lose. It is a one-way street.

I am the lawyer for the telephone company. I am guaranteed a rate of return and if you do not give it to me, I say it is an unjust taking without compensation under the 5th Amendment of the Constitution, and constitutionally you have got to give me rate of return.

I just do not see where the user wins out on this particular scheme of yours. You know, we have all been indoctrinated—I am now in my 23rd year—that rate-of-return is working, and we become very askance when all of a sudden a Commissioner comes up and says, it is not working and you have got X thousands of people and so million many dollars in investments, and billions, and all of a sudden there is chaos.

We are trying to maintain, rather than have chaos, the wonderful AT&T service that we have had. It has been the best in the world and continues to be the best in the world, and its incentives are for that of a service organization. There is a discipline instilled, and you do not have to just make money. They do it, and they are very proud of it. Over the years, they have been doing that.

Your premise is that they have been a bunch of lethargic, uncompetitive, unproductive bums, and now you are going to straighten them up and make them fly right, all at the expense of the user. Because the user, he has to wait for four or five years for any kind of adjustment. The company comes in immediately and files, and otherwise ultimately says constitutionally that is a taking without compensation, under the 5th Amendment. They cannot lose.

I can see the full court press by AT&T and the investment world—since you have mentioned investments—every one of the houses at the New York Stock Exchange said hurry up and buy AT&T stock. They are going to get this price cap and they are going to make a fortune. That tells me, all of a sudden service is going to suffer. What is your comment?

Mr. PATRICK. Senator, you have made at least three points. Let me comment on each of them. As to the notion that the user is going to be worse off, that there is nothing in it for the user until sometime down the line, that is not correct under our proposal.

Consumers will be better off both in the short run and the long run. The reason they will be better off in the short run is because we are going to cap prices and bring them down every year by 3 percent, which is .5 percent per year greater than the observed annual productivity of the industry under rate-of-return.

So right off the bat prices are reduced by 2.5 percent, which is the amount of productivity improvement we have observed under rate-of-return, plus .5 percent. So prices are coming down in the short term immediately for consumers, faster than they would under rate-of-return. Number one.

Number two, in the long run they are better off because having caused these companies to reveal to us how efficient they can be for the first time, we can then adjust prices down in a dramatic fashion with evidence that we never would have had but for price caps.

The second point you made was this notion that the companies cannot lose. That is not correct, either. The companies can lose under this program. Under rate-of-return we essentially say, tell us what your costs are and add 12 percent to it and that is what we will allow you to charge.

Under price caps we give them a mark, and we say, if you can beat that mark, if you can do even better than that mark, which is better than we have seen under rate-of-return, then you can earn a little extra money, but if you cannot, then you are going to have to suffer losses. You are going to have to suffer earning returns which may be potentially under what they would earn under rate-of-return.

Now, to give your question its due, there is some point at which a company is not covering its cost. It does have a legal right to come in and petition the Commission to increase its rates. But that is well below the 12 percent rate-of-return figure, for instance, that

we talk about today. That is at the bottom of the zone of reasonableness. Within that zone there is the potential for losing in comparison to what companies earn today under rate-of-return system.

The third point you made goes to service quality. I believe very strongly that service quality will improve under the incentive regulation, because we will encourage companies to deploy efficient technologies, modern technologies, and we will not punish them by adjusting their rates if it results in increased profits in the short term.

Secondly, service quality is something that we maintain a check on by monitoring, by regulation in effect, and we do not propose to eliminate that regulation. Indeed, we propose to increase the degree to which we monitor quality criteria in the rate cap environment.

The CHAIRMAN. Well, that is what you intend to do, but the truth of it, you talk about the company losses. That is what is not going to happen. There could be losses under your scheme, but it will be to the consumers.

I am running the telephone company and I put out there now, wild catting and making investments, and irrespective of how I make them, I want to make sure I make my money for my stockholders and everything else.

Totally—when my phone goes, instead of coming out this afternoon, immediately, to fix it I say well, I will put you on the list and I will come next Monday. We just cannot get out there any sooner. You can put out all the regulations you want, you cannot fine the company. You have never done that.

You just really are going to take a good service organization and change the discipline and mentality of that to a service group and ruin one of the finest companies I think we have ever head, because they are not going to lose money. They know how to make money, and that is what your whole scheme is: We want you to make money, and we are going to put a price cap.

That productivity sounds good in the political hearing room, but money talks in the economic world and you put me out there to make so much money, I will make all I can, and let the service go right on down, and I do not have any competition on the service end because there is nobody else with that license.

I have got all kinds of competition on the equipment and the investments. None on the service end. So where is the competition on the service end that is going to make me get out there and serve? What you have done is really said forget about the service now, we have given you that, and make money as you will with this particular cap. I am bound to let the service go because I do not have any competition on service.

Mr. PATRICK. Well, senator, as I said, I disagree with you on the question of service. You make this observation with respect to the lack of competition. Competition causes companies to want to better serve their customers as a result of the competition.

The CHAIRMAN. Not if you do a price cap. There is no pride, or any particular award in service. I have got an exclusive. I am an AT&T and I have got me a known cap, and however I can make money with that known cap I am going to do it, and number one

the service goes down because I have got no competition on that. Absolutely no competition on that.

So if I have got 20 repair trucks in this little home town, well the first thing I do at the board meeting is say, let us cut back three repair trucks and three repair crews on that service and let us get that money and invest it and try to put MCI out of business, or put somebody else out of business, and go right on down the list, and cut the price here and cut it there. I know how to find money from service and put it into your so-called competition for dollars.

That is not what the Congress wants. This is a service organization, AT&T. We are not setting up the private free enterprise system.

Mr. PATRICK. Senator, as I was going to say earlier, number one, the service quality problems of the most pronounced nature that we have suffered recently occurred under—in a rate-of-return regime at or about the time of divestiture. We had a number of service quality problems—delays, what have you.

The Commission corrected those problems working with the industry, by monitoring, by regulation, and we propose to continue that monitoring process, indeed, to strengthen it under the rate cap regime, although I believe the incentives to be efficient, including that of deploying efficient technologies and providing better service, will be even greater under rate cap.

Secondly, this point about competition was the point I was going to make earlier. Competition does give you a positive incentive. The beauty and the value of rate caps is that it creates a similar incentive, even absent competition, because if you can be more efficient you have the possibility of earning additional dollars, although because of the way the cap is formulated consumers get to share in those benefits first.

Service quality—if you reduce service quality it increases cost. You have service calls to make. You have to get people involved. That increases the cost of the carrier, so a carrier under price caps is not going to allow quality to degrade. If you reduce quality, you reduce your revenues as well, because it increases the blocking rates the telephone companies suffer. That reduces revenue. Again, a carrier is not going to allow that to happen in a price cap environment.

Efficient equipment—which is the sort of equipment that we think will be deployed, there will be more of an incentive to deploy, in a price cap environment—tends to be high-quality equipment.

We also are retaining our 214 authority. That is the authority to approve construction projects. At that time we review and monitor the type of equipment, the quality of the equipment that is being deployed. Quality standards are tariffed. We do not propose to change that.

You say competition. Certainly, quality is a term of the competition that exists in the interstate market today. AT&T and its competitors compete on quality terms every day, and so that is a restraint.

You say less competition at the LEC level. There is less competition, but they are servicing very sophisticated inter-exchange users that demand a quality interconnection and by and large it is pro-

vided. Where it is not, we monitor it, and we will continue to do that.

I do not think quality is going to suffer. In fact, I think the industry is going to have more incentives to be more efficient, and that translates into good quality. If it does not, we will catch it, and that is no different than today.

The CHAIRMAN. Well, of course, what you are trying to do is deregulate so we can get more competition, but on the matter of service where there is no competition, you say you are going to regulate, and it sounds smooth.

We have had an experience on the deregulation of the airlines. We have had an experience on the deregulation of the Savings and Loans. We have had an experience in communications on your deregulation. The quality has gone down, and it sounds good but we know basics.

You say you just find out the cost of the telephone and add 11 or 12 percent. I have been here 23 years and I have not been able to find out the cost. We have had the best of AT&T. We have tried every which-way in the world. That is why you have got Judge Green in charge, because we in the Congress tried to chase them around this hearing room. We never have found out. Could not find out. Could not learn.

You have got Alfred Kahn saying the long-distance was being supported by the locals. The others say, oh, no, long-distance is supporting the local rates. We never could find out one way or the other. But I appreciate it. Thank you, Mr. Chairman.

Senator INOUYE. Senator Kerry?

Senator KERRY. Thank you, Mr. Chairman. I could listen to my Chairman forever, here. Mr. Patrick, I appreciate the opportunity to follow up with you, and I thank you Mr. Chairman, and Mr. Chairman, for continuing this process of trying to find out where we are going, although it is becoming more evident I suppose by the day.

I do want to thank you, Mr. Chairman, for responding to some of the concerns which we expressed last year, and for coming back with yet further revisions, though I must say that I think there still remain a number of questions regarding those, and I would like to ask some of them if I may.

One of the concerns, obviously, is—and it has been expressed, I know, in the House hearings, and we have expressed it privately—is just a general concern about price increases and what happens to consumers.

Constitutionally, if a carrier proves that a certain rate is confiscatory there is redress. A constitutional redress, among other things, and that principle has been well-established and it has obviously served the industry well.

The question is, though, what about the consumer? Is there anything in your plan, or in the current structure, that you believe resembles a confiscatory rate doctrine that is designed to alleviate the consumers in the event that there is an excessive rate under the cap?

Hypothetically, if AT&T residential rates are increased 20 percent, but they remain legal under the price cap plan, would the Commission institute or hear a motion from telephone consumers

that would be designed to lessen that impact of a domestic rate increase?

Mr. PATRICK. Senator, let me start by saying that the Communications Act requires that rates be just and reasonable. The case law has suggested that there is a zone of reasonableness that is bounded at the low end by the shareholders of the telephone companies' right to a reasonable return, a right at least to cover costs of providing service, and at the top end by consumers' right to have reasonable rates. But there is a zone.

The specific answer to your question is yes. If we received a complaint that makes a case for the proposition that the rate of return and therefore the price being charged is unreasonable, then the Commission would take appropriate action in that case.

The important point to remember here is that this is not a zero sum game. If we are bringing prices for consumers down faster than we would have under rate of return by a productivity deflation factor that is greater than observed productivity, consumers can be better off at the same time the companies are better off if they can beat that mark. But consumers are the first beneficiaries of the improved productivity because we build up front into the price deflation greater than what we have observed historically.

But a specific answer to your question is——

Senator KERRY. When you say that you build up front, are you referring to the 2 percent restriction on residential rate increase or is there another ingredient to that?

Mr. PATRICK. I am referring to what we call the consumer productivity dividend which is a half percentage point over and above the 2.5 productivity annual increase or improvement that we have observed historically.

Senator KERRY. Well, if inflation is at 7 percent and you take the two ingredients of the productivity and reduction, the 2.5 and 5 percent, that is the 3 percent reduction, so you have got 4 percent plus your 2 percent cap, you would still have a 6 percent increase, correct?

Mr. PATRICK. I am sorry, I am not that fast with the numbers. Jerry, maybe——

Mr. BROCK. Yes, in a straightforward sense there are some extra adjustments for the way access charges would flow through but in essence, yes.

Mr. PATRICK. But, Senator, can I comment on that because this is another sort of—I do not know that it is a misimpression, but I think it is worth nothing that in the rate-of-return regime that we have today, the prices that a carrier can charge are obviously based in part upon the cost of money, the cost of doing business, some measure of inflation. So, that is the same as we have today.

What is different about the price cap proposal is as against that positive inflation, you have a reduction by 3 percent in real terms which is greater than we have observed under rate of return. So, consumers are still better off. I cannot make inflation go away.

Senator KERRY. No, I understand that, but I am just trying to get a measure here in real terms if inflation is at 7 percent. And after your productivity and consumer dividend adjustments would total about 3 percent you would then have an increase of 4 percent plus your permissible maximum allowable increase of 2 percent, cor-

rect? In residential rate you are saying there is a 2 percent annual increase permitted?

Mr. PATRICK. No, it does not work quite that way.

Senator KERRY. I want to understand exactly how this 2 percent—I mean, you propose to let residential rates rise by no more than 2 percent on average above the price cap, is that right?

Mr. PATRICK. That is what we call—that is an additional restraint on the composite average residential rate of services within the basket, but let me explain. You want to understand exactly how this works. It is a bit complex. Let me explain.

The services provided by AT&T are divided into three baskets; that is a change from our original proposal. One of the baskets is residential/small business services. The reason we have a separate basket for those services is so that residential consumers will have a fair share of the flow through effects of access charge reductions, what have you. And so there will not be cross-subsidy as between these services and more competitive services.

The weighted average of prices within that basket are capped and that cap reduces every year by 3 percent in real terms. That is the 3 percent factor. That is the consumer productivity dividend plus observed annual productivity.

We have built into the model additional restraints below that cap in order to prevent rate churn, in order to prevent adjustments within the cap that would adversely affect consumers, and that is where we get into this matter of the 2 percent.

What you have are two additional restraints. One is that no service rate can rise underneath the cap, say, day MTS or evening MTS, more than 5 percent per year. And in addition to that, the composite average residential rate, which is the weighted average of prices paid for those services by residential consumers, cannot rise by more than 2 percent. So, those are additional restraints over and above the 3 percent deflation that takes place every year.

Senator KERRY. Well, if I follow that correctly, and I am not sure anyone can, but I am going to try, I still come back to the fact that there can be, under that explanation, have a 6 percent increase in residential rate on an average of one year and allowing, as you said, evening rates—you said the evening rates can rise 5 percent as long as the day rates decline by an equivalent dollar amount, is that correct? So, evening rates can rise as long as day rates go down an equivalent amount?

Mr. PATRICK. The entire aggregate of services has to be below the cap.

Senator KERRY. Which cap?

Mr. PATRICK. The cap for the entire basket of residential services that, remember, is being deflated every year by 3 percent. But, yes, a 5 percent reduction can be offset by a 5 percent increase and that, I might say, is what we have observed historically under rate of return to be the amount of adjustment which we tend to see in these individual services categories. So that does not represent a change. What it represents is an articulation of an additional restraint which is, as I say, something that we have observed historically and is necessary even as the costs change, technology changes, et cetera.

Senator KERRY. Well, perhaps I am puzzled, and I do not know if I am under a time gun here or not, but I have a number of other questions. But maybe we can spend some time. I want to understand that even better than I think I do now because the way I think I understand it that when I couple the 5 percent with the other part of the equation that you have described, there is a potential, I think, for as much as a 10 percent increase in evening and night and weekend rates for residential customers over a two-year period, which strikes me given the rate of productivity and other technological changes as problemmatical in the context of where we are going here.

I must say to you I am not sitting here with any predisposition to say that inherently price caps are not a better sort of way to perhaps move, and I can see the restraints of rate regulations and so forth. But I am concerned that there are major rate increases for residential customers in store here, particularly with the day and night tradeoffs, given who makes calls at night versus day and the business versus residential balance there.

Mr. BROCK. Senator, if I may perhaps clarify something here. All of these calculations are after adjustment for the access charges. Now, in the past we have had substantial decreases in access charges and, therefore, we could make the same types of calculations, and you still observed in actual fact the dollar rates of night and weekend going down.

My point is, we have been making these kind of relative adjustments over the last several years, and the proposed rules here are a formalization of the kind of administrative decisions that have been made the last several years in individual tariff filings. There is really not a change or a loosening up from that practice.

Senator KERRY. Well, I hear you in theory, but AT&T recently applied to reduce rates by $533 million, and most of that came from pass-through savings on the 30 cent per month increases in charges to users. But those rate reductions have not been applied evenly among customer groups.

Mr. PATRICK. Well——

Senator KERRY. Let me just finish for a moment because I want to throw this at you and get your reaction to it.

Daytime calling, which is used primarily by businesses, would be reduced by 3.8 percent. Evening rates will decline by only .4 percent, and night and weekend rates will stay the same, which means the residential customers who make long-distance calls almost exclusively at night and on weekends will not wind up receiving any rate reduction under that. So, my question is, is that the type of pricing that we are likely to experience under the price cap process?

Mr. PATRICK. My answer is no. Since we have the benefit here of the person who actually works the numbers when we are talking about flow-throughs, I will let Jerry comment on this, but I did want to say, number one, that what you have described is AT&T's proposal with respect to how access reductions should be flowed through. You are not talking about what the FCC has approved.

We will review carefully their proposal, and we will make the final decision with respect to what is appropriate in the way of flow-throughs. I have committed—in fact, I committed to this Con-

gress last year to ensure that the flow-through of access charge reductions was done in an equitable fashion and whereas I have not reviewed and therefore do not want to prejudge AT&T's——

Senator KERRY. But, you see, that is precisely what concerns me. You can do that now. But once price cap is in effect, you will not be able to do that.

Mr. PATRICK. But what we intend to do—no, it is just the opposite. It is just the opposite because the fact of the matter is today there is a great deal of discretion in the bureau and at the agency with respect to flow-throughs. And the rules are not clearly articulated.

One of the benefits, one of the public benefits of the price cap regulation is that we will articulate and get up front the rules with respect to flow-throughs and what have you, and we want to ensure that they are equitable and we will.

In the case of price caps, there will be a flow-through of access charge, or any exogenous cost, reduction to the cap. That is, if the cap goes down, a service price adjustment takes place. So there is right off the bat a more equitable distribution of these reductions.

That having been said, Senator, there is and there was yesterday expressed on the House side an interest in exploring precisely how these changes and these mechanisms would relate to the various service categories. And I intend to pursue those conversations with various other members.

We have been happy to, as you suggested earlier, sit down and work some of these numbers. I can assure you that overall I am committed to the proposition that under caps consumers will be better off and they will be better off or at least as well off with respect to equitable flow-throughs of any exogenous cost reduction.

Senator KERRY. Mr. Chairman, I know my colleagues are here. Do I have a little longer?

Senator INOUYE. Go ahead.

Senator KERRY. The productivity index of 2.5 percent has been the subject of a fair amount of concern and controversy. Consumers and industry have criticized the number that you have selected as really not adequately reflecting the level of productivity, and I know you are familiar with these arguments, but the reliance on these historical productivity measures seems to me to not reflect the technological changes that have been put in place and are occurring. And, in fact, the historical study that you rely on for the period 1972 to 1978 has productivity factor of 3.9 percent.

In your letter of February 13th to the Subcommittee, you said you would not adopt the Bureau of Labor statistics productivity level because, "It does not at present exist, and it is not clear when the index will be established." And you further maintained that it would not be sensible for the Commission to formulate an index of its own.

In light of the fact that the productivity index is really so critical to the functioning of the price cap plan, why this sort of—and I do not want to characterize it and malign it—but why this sort of cavalier approach to the Commission's willingness to take greater account of that index and what it means to this whole plan?

Mr. PATRICK. Senator, Mr. Brock is the person who has actually run the numbers with respect to these various studies and ana-

lyzed them in detail, and so I want him to comment on your very important question. I want to comment on it generally by saying that we have taken anything but a cavalier attitude with respect to the matter of what the appropriate productivity number is. We have analyzed over a dozen different analyses of historic productivity and various computations of productivity.

We feel that in general—and I think it is generally accepted—that actual historical experience is probably a safer measure of productivity than some predictive computation, and so we are relying upon historic data, but it is not just data from the seventies or from 50 years ago. We also have very solid data with respect to AT&T's experience post-divestiture that corroborates our view that the productivity of the industry over and above general economic productivity and productivity in the economy is between 2 and 2.5 percent.

Senator KERRY. Are you averaging that out? I mean, what happened? Are some of the LECs clearly more productive than others? Some have newer equipment, some do not? How do you arrive at a fair competitive structure given the differentials in productive capacity of those entities?

Mr. BROCK. The numbers——

Senator KERRY. And could I throw in one more part of that question and maybe you could answer it, kit and caboodle? In your first notice, you delegated a significant amount of discussion to the British system, and you have continued to, I think. You know, in your January 13th letter you said, "The experience of the United Kingdom in regulating BT under incentive regulation provides persuasive evidence of the benefits of incentive regulation." You constantly compare our proposal to theirs, and yet, they have had a 50 percent increase in their productivity factor from 3 to 4.5 and you say that is irrelevant in arriving at your model, "irrelevant."

And so, I remain troubled, and that is why I want to know. They have had a 21.4 percent profit increase in British Telecom, and yet you are saying that this productivity differential is irrelevant to what our profits will be.

Mr. BROCK. Senator, the number that we are currently talking about for productivity is an AT&T number. You noted concerns about different companies and some higher productivity and some lower, and we acknowledge those concerns with regard to the local exchange companies, and that is one of the reasons we are going out for further notice and further comment with regard to those companies.

But with regard to AT&T we are simply examining a single company, and there we do have a great deal of data that is reasonably consistent. Although we certainly acknowledge and hope for major technological change in the future, we have also seen major technological change in the past period over which these historical productivity numbers have been computed.

For example, the development of microwave, the development of high capacity coaxial cable, the initial development of fiber optics are all already incorporated into those productivity numbers. In general, in productivity studies you get the best examples by looking over a long time series so that you get rid of anomalies in the data that may occur over a single year period.

And you made a passing reference to the Christiansen study, the econometric study of total factor productivity which was done from the years 1947 through 1978. We consider that a very carefully done study and one that is worthy of considerable weight. We would put somewhat less weight on any single time period within that study than we would on the overall study.

The study actually calculated separate productivity numbers year by year, so you can say what is the productivity in 1978 compared to 1977. Those are not terribly meaningful numbers because there is a great deal of uncertainty on very short series that tends to cancel out or, in a statistical sense, become much more accurate over the long period, and that is why we put more emphasis on the entire study than any time period within it.

Senator KERRY. Well, after listening to the comments of Chairman Hollings about the chasing of the money is there conceivably a way to build a better safety net into the structure so that if those productivity rates prove different or if there is significant profit gap occurring as a result of an error in judgment that you do not have to go through a long redress of grievance process that in effect disadvantages consumers? I mean could there not be a structural process by which you are going to say in the event of productivity rates higher than anticipated X, Y and Z will follow?

Would that be something you would think about here?

Mr. PATRICK. Certainly. Those sorts of mechanisms have been suggested in the record, and we have explored them because there is some record evidence of variability among the LECs with respect to productivity. We are exploring one such mechanism, the so-called stabilizer.

As to AT&T, I do not believe it appropriate to add that sort of mechanism at this point for a number of reasons, one of which is that we are confident that the number that we have chosen not only reflects productivity, but is in a rather aggressive mark with respect to productivity at 2.5. We add to that the additional half point of price deflation.

But the answer to your question with respect to safeguards also has to be that the Commission has explicitly chosen to retain the filing of data which will give us information with respect to AT&T's rate of return experience under price caps and if there is some sort of problem or anomaly or something unanticipated, the Commission can take corrective action.

And in that regard let me reference back to your reference to the British experience. The fact that after the first several years of utilizing the price cap system in Britain, they have been able to move the productivity mark from 3 to 4.5 is I think a great testament to the efficiency enhancing incentives that are created by the price cap system.

I would hope four years from now to have a solid basis upon which to either reduce the base prices themselves down dramatically to recoup those gains for consumers or to articulate a more aggressive mark for AT&T, AT&T having revealed how efficient it can be because it now has proper incentives as a result of the plan. So, we think there are many safeguards built into the system.

Senator KERRY. What I would like to do is maybe reserve the right to follow up a little bit in writing.

I would like to ask one more question for the record here which I think is important philosophically. In the material that you have submitted to the Committee in these last months you have frequently talked about the role of competition in the price cap system.

It has sort of been at the heart of your approach and, in general, I think it is fair to say that you have argued consistently that the price caps will work best in the presence of competition in the first publication on price caps, the agency working paper number 22, where the system of price caps was never considered for the local exchange companies, the presence of at least nominal competition was seen as necessary for it, and it obviously is not present there or was not at the time.

Then you reversed yourself in the next notice stating, "Making the existence of competition a prerequisite in price cap regulation is illogical."

Since that time, I think there has been some further confusion on the issue because you have expressed a concern about the lack of "meaningful competition" faced by the local exchanges, and you have often referred to the level of competition and categories of the AT&T market as a safeguard for the consumer and so I am really interested in hearing you perhaps clarify for once and for all what is the role of competition in the price cap, particularly since you backed away from the automatic stabilizer which you have just talked about. You backed away from that for the local exchanges, and you have removed the lower band for AT&T LECs.

So, where is competition now in this equation?

Mr. PATRICK. I view the price cap proposal that we are considering to be a more efficacious, a more effective, a more pro-consumer way of regulating dominant carriers. We are supposing that both the LECs and AT&T have some measure of market power and therefore must be regulated. The question then becomes how do we best regulate a dominant carrier, a carrier that has market power.

And I believe very strongly that the price cap regulation will be a more effective way of exercising that regulatory restraint. Therefore, it is my position that competition is not necessary to the deployment of a price cap regime, but it is certainly an additional safeguard where it exists.

In the case of AT&T and interstate competition there is going to be additional downward price pressure, and the incentives that are created by competition are consistent with and complementary to the incentives that are created by the price cap regime. It is an additional restraint, but I do not view competition to be necessary to the utilization of the price cap system.

The British use it, of course, and they adopted it initially at the same time for both local and their inter-exchange service.

Senator KERRY. Mr. Chairman, thank you very much for your indulgence. I appreciate it.

Senator INOUYE. Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman. And thank you, Mr. Chairman, also for being back once again. I looked forward to your presentation. I am sorry I missed it and perhaps you have covered some of the thing that I would like to get into.

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You talked about the need to perhaps propose a different alternative to the rate of return. I am concerned that some could make the case that things are going pretty well under the existing system. Why change it—if it is not broke, do not fix it.

And they point to the fact that we have had technological advances, we have had growing traffic volumes, all of that, and we have had steadily reduced cost of a telephone call over the past many, many years. And that has all been done basically essentially under the rate of return.

To change something you have to prove that this new system is better. Consumers have benefitted a great deal from the existing system and the basic question is if it is not broke, why fix it. Can you respond to that?

Mr. PATRICK. Yes, sir, Senator. It is a question that comes up frequently. In fact, we talked about it a little bit earlier.

I think that the system—well, let me observe generally that hopefully we learn something after fifty years or so of regulating the industry pursuant to the Communications Act. One of the things that I think we have learned, the academic community learned it first, was that rate-of-return regulation creates misincentives that hurt consumers. Having realized that, we are now setting out to correct those problems.

On a less esoteric level, let me tell you——

Senator BREAUX. Well, is that premise correct, that they hurt consumers, when you see consumer prices going down? I mean, is that not starting from a faulty assumption, that they have been hurt?

Mr. PATRICK. No, Senator, I do not think it is. You have to ask in comparison to what. Yes, prices have fallen. They have fallen as a result of a number of things and most substantially because of the Commission's subscriber line charge program that resulted in reductions in access charges which we caused to be flowed through the consumers through AT&T. That process has come to an end.

Let me note that the process of flowing through exogenous cost changes like that will continue under price caps, but when people observe gee, the system seems to be working fine, look at all the price reductions we have had, I have to say that it is because of these changes in what we call exogenous costs. That process will continue under rate of return or under a price cap proposal.

Secondly, 2.5 percent productivity improvements over the last several years are thought by many who are familiar with the technology and who have observed the sort of technological improvement and productivity improvement we have seen in other industries like the computer industry, for instance, not to be fast enough, that we could do better. The question is how do we encourage the industry to do better?

Again, I come back to the proposition that you always have to ask, in comparison to what. I think that we could do better. There is empirical evidence of that in one of the earlier hearings. There was a request that the Commission look at a distinct period of time and attempt to identify what in the way of rate based padding or gold plating the Commission was able to identify and whereas that is a very difficult process, we have identified from time to time in

the past investments that in the opinion of the Commission were not necessary.

The ratepayers are paying for that, and so ratepayers may feel like things are pretty good, but it is also pretty clear that ratepayers could be a lot better off. If we can put an incentive structure in place that will cause carriers to reveal to the Commission, maybe for the first time, precisely how efficient they can be because it is in their interest to try to beat the productivity mark that we have set, consumers are going to be better off in the short run as a result of the formula that we have articulated. They also are going to be dramatically better off in the long run because once that information is revealed, we can adjust prices down in a dramatic fashion, which is exactly what has happened in Britain.

Senator BREAUX. Has the Commission staff tried to extrapolate any period of time that we have operated under a rate of return system and plugged in a price cap to those scenarios to see what would have happened in that same time frame as a comparison?

Mr. PATRICK. Yes, sir, we have done that. Chairman Inouye was interested in having some empirical data and some computer model work done, and that has been done, and Mr. Brock here is the gentleman who did a lot of it and has studied a lot of it. And let me comment on what the results were. Let him comment.

Mr. BROCK. We did what we call a backcast of the price caps for the post-divestiture period for AT&T, and we found that if this system had been in place and we had used a productivity number of approximately 2.4 percent rather than the 3 that we intend to, we would have come out with the same prices we actually observed.

In other words, if the price cap with the 3 percent productivity number had been in effect over the past four years prices would have been going down at about 1/2 a percent or 6/10 of a percent faster than they actually did in the observed period.

Senator BREAUX. I guess there is no way of determining what type of productivity you would have gotten out of that or technological advances under the system. The only thing you could predict is prices probably would have come down by the figure you just spelled out?

Mr. BROCK. Yes. The most——

Senator BREAUX. You cannot speak to quality of service, I guess. You can only speak to what projectingly would have happened from a price standpoint.

Mr. BROCK. The prices are the easiest thing to predict. We have no reason to believe that service quality would be significantly different under either method of regulation.

Senator BREAUX. One other point. I know that in your appearance before the House, a number of questions were raised with regard to rural customers and a concern for the quality of service and what would happen to particularly rural areas. Would you for this committee, if you have not already said it, respond with your answer to those rural concerns that were raised?

Mr. PATRICK. Yes, Senator, I will for your benefit. We did talk about that a little bit earlier. There are a number of accommodations and let me—I would like to repeat some of those points that we made earlier with respect to the small company situation.

The small companies were concerned that the price cap proposal would in some way jeopardize the level of support that they enjoy through our various subsidy mechanisms for high cost companies. That was never our intention and it was never the effect, in fact, of the price cap regime.

We have now made that very clear and will make it very explicit in the item that there will be no compromise of the various subsidy mechanisms that we have for high cost companies.

We are retaining a rate of return prescription for purposes of computing that support, and we are retaining the filing of data that is necessary to ensure that the small companies continue to enjoy the various subsidies that we have in place today.

The small companies are interested in having an opportunity to elect on a voluntary basis price caps after the depooling process in April of this year, and we have provided for that.

We have indicated that we do not see price caps as disturbing our practice of utilizing a unitary rate of return, which is important and goes to the same issue of support. And we have made a number of explicit assurances with respect to the matter of geographic rate averaging which you are familiar with and are important to the small companies.

Most importantly, we retain the support mechanisms which lessens the pressure to deaverage. We state explicitly our commitment to rate averaging. We indicate that we will suspend—will suspend—and investigate any tariff that proposes rate deaveraging.

We—I might add that I have also had a number of meetings with small company representatives, and it is my general impression that they are quite satisfied. In fact, we received a letter to that effect from OPASTCO.

Senator BREAUX. Well, I think those are major improvements in that area.

Thank you, Mr. Chairman.

Senator INOUYE. Thank you.

Senator Gorton.

Senator GORTON. Since my last round of questions, Mr. Patrick, I have been given yesterday's testimony, which I am sure you must be familiar with, from the Chairman of the Utilities and Transportation Commission of my state, Sharon Nelson. I have two questions which arise out of a brief quick reading of that testimony.

The first is her criticism of you both with respect to your way of phrasing your proposal as well as to the substance by denominating your proposal incentive to regulation, which is what she describes as the historic method of describing what she says is a quite different system in New York.

Could you tell me how the New York system differs from the one you propose for AT&T and whether or not you consider those differences and what your general reaction to them is.

Mr. PATRICK. The New York plan has undergone a number of changes, and so I am probably not the most expert at describing it.

I can tell you in very general terms that when you talk about incentive regulation, there are at least two ways to do it. One is a straightforward sharing mechanism or a banded rate-of-return mechanism where you explicitly provide up front for some sharing of revenues over a certain mark. That is something more similar,

as I understand it, to the New York plan. It partakes of this aspect of explicit sharing of a certain percentage, 50 percent, where the carrier earns over a certain amount.

My concerns about that sort of plan are that you reintroduce into the scheme all of the same disincentives that you have in rate-of-return regulation; that is, you give the carrier an incentive to doctor its books, to cross-subsidize or to otherwise ensure that it demonstrates that it never earns over the magic mark that would cause us or cause it to begin to have to share revenues. And so you reintroduce into the system the same misincentives with respect to accounting, with respect to cross-subsidies.

But probably more importantly, you do not give the carrier the maximum incentive to be absolutely as efficient as it can because at a certain point you start taxing that efficient behavior.

The other problem with the New York style plan, in my view, is that consumers only share in the benefits of the incentive regulation once you get to the magic mark. And, to my knowledge, the major carrier in New York has not reached that magic mark. And that to me is not surprising.

In the price cap proposal that we have as to AT&T, we ensure that there is sharing with consumers up front by taking a productivity mark, a goal for the carrier that is more aggressive than what we have observed historically in the way of productivity improvements.

Historically we have seen about 2.5. We are going to deflate prices, which is a direct gain up front to consumers by 3 percent a year, give that as a mark to the carrier, and then give them a full incentive to try to be as efficient as they can.

The comeback, of course, is well, what if they are very, very efficient? My first answer is good, if they are very, very efficient, thank God we have finally caused them to reveal how efficient they can be because I can assure you that at the appropriate time, we will adjust prices downward and capture that efficiency, those benefits for consumers.

So, reasonable minds can differ. There are different ways to do it.

Senator GORTON. The second critique I pick out of her testimony here has to do with the way in which you monitor and review this performance particularly I think, as I read her testimony during this first three-year period. She compares that monitoring and review as well as how ambitious your program is that this 3 percent per year compares quite unfavorably with the experience in the United Kingdom.

Can you compare what you are doing both substantively and with respect to review to whatever the similar experience in the U.K. are?

Mr. PATRICK. Well, I could not give you a precise comparison of all of the mechanisms that OFTEL, the Office of Telecommunications in Britain has used, but my general impression is that it is fairly similar; that is, that in the U.K. they do receive information with respect to the performance of the carriers on an interim and ongoing basis and then they also provide for a generic review of the experience and a recomputation of the formula. They have had one

such generic review and it resulted in bringing the productivity deflater down from 3 to 4.5.

That is generally what we contemplate.

Senator GORTON. Excuse me. When did the United Kingdom start this incentive type regulation?

Mr. PATRICK. I think it was about 1984.

Senator GORTON. So, there is some real experience with it?

Mr. PATRICK. There is some real experience, and the British started off with what they called RPI minus three, the Retail Price Index minus three.

Frankly, the formula was not as complex—I am not sure whether that is an indictment or praise—as the formula that we are pursuing, but they generally deflated prices by three points in real terms and they found after a period of time that it did have a beneficial effect upon the incentives of the carriers to be more efficient, and they found at their first review period, which was conducted not too long ago, that as a result of the companies getting used to working in this environment and improving their efficiencies, et cetera, that they could bring the formula down to 4.5 or add an adjustment of 4.5 per year, which is exactly the sort of experience that we would like to see here.

That having been said, it is difficult to compare—in fact, it is misleading to compare—the British experience other than in those general terms to the American experience because the company in question, BT, is quite different. It was privatized only—well, in 1984, as a matter of fact, coincident with the initiation of this type of regulation. It has a very different capital structure, debt structure, etcetera. And so it is difficult to compare them precisely, but in general terms they have been very pleased with the price cap experience and it is moving prices in the right direction.

Senator GORTON. Thank you, Mr. Chairman.

Senator INOUYE. Thank you very much.

I will set aside my doctor's admonition and ask one question. When I arrived here this morning, I was handed the morning's issue of Communications Daily, and the opening paragraph describing yesterday's meeting says, "Members expressed strong reservations on plan's potential impact on consumers, particularly in rural areas and said they wanted greater safeguards built into package that includes price floor, windfall profit sharing, automatic stabilizer for AT&T."

For the record, may I have your comments on price floor, windfall profit sharing, and automatic stabilizer?

Mr. PATRICK. Yes, sir, Mr. Chairman. Those issues did come up yesterday. You will have to excuse me, because I will have to lay some foundation for these questions.

The matter of price floors has to do with whether the Commission should provide for a longer period of review any time a carrier under the price cap plan proposes to reduce prices lower than 5 percent per year. The idea is driven by concerns about anticompetitive conduct and predation. It was an idea that was floated in one of the earlier notices of proposed rule-making.

I indicated in my correspondence with the Congress that I was thinking about not having such a floor, in light of some changes that we have made to the proposal based upon interaction with the

Congress. Specifically, we have proposed to move from two baskets of services for AT&T to three baskets of services, and we think that that will have the effect of making cross-subsidies between these various categories of services much less likely, and that goes to this predation question.

It is fair to say that this question of the floor is something that is still being discussed. I was very forthcoming and candid in my correspondence with you and Chairman Dingell about our thoughts on that. I will repeat them by saying this as to floors:

The purpose of competition is price reductions. Generally, we want to see prices move in a downward direction. We do not think it is likely that carriers are going to price services below their actual cost, for all sorts of reasons, some of which are intuitive and some of which have to do with the fact that in a price cap regime it is very hard to recoup those losses.

Under rate-of-return, you price below cost, and you pump up your price over here and you cross-subsidize. Under caps you cannot increase your price over here because it is capped. We also, because we have disaggregated the baskets further, think it is less likely that that sort of cross-subsidy will take place, and therefore we are exploring the idea of not having that floor.

The other thing about the floors is that the question of predation is a factual question. It is a question of whether or not the price covers the reasonable cost, or some measure of the cost, of the company. That is a question which really does not have much to do with whether you have just reduced your prices by 5 percent or 10 percent or 2 percent. It is a factually-specific question. We think it is probably best dealt with in the context of complaints. That would continue under our proposal.

The matter of sharing, the sharing idea—well, first of all the word is another word for stabilizer. We have talked about employing a stabilizing mechanism as to the LECs because there is some record evidence of variability with respect to the LECs, and so that is an idea that we are going to put out for further comment.

We are not recommending a stabilizer with respect to AT&T for a number of reasons which I just explored with Senator Gorton, having to do with the fact that we are quite confident of the productivity number we are using for AT&T, and we have the additional restraint—downward price pressure of competition—and because we do not want to dampen the incentives. We think that we have constructed a system that involves sharing up-front.

I guess I did the last two at once: sharing and stabilizers.

Senator INOUYE. I would just like to note that of the 14 members of this subcommittee, 11 attended the hearings this morning, which should indicate the level of interest expressed by members of this subcommittee.

Senator BREAUX. Mr. Chairman, could I ask one additional question?

Senator INOUYE. Please do.

Senator BREAUX. Thank you. Let me talk about tariff 15 that AT&T has filed vis-a-vis the price cap proposal. How is that interrelated? What happens under price cap with a tariff 15 filing, and what about the nondominant carriers that are concerned about

that extra added flexibility for a dominant carrier that gives them serious competition problems?

Mr. PATRICK. Well, senator, it is not related. We have proposed to exclude from the price cap regime tariff 15.

Senator BREAUX. So suppose the price cap goes into effect and you approve tariff 15, what is the situation then?

Mr. PATRICK. The tariff would be essentially subject to a separate set of rules and accounting principles, which is not unusual. We have a number of tariffs in place in the rate-of-return environment that for any one of a number of reasons are subject to an accounting order, or separate rules, or separate administration.

In the case of tariff 15, I do not want to talk too much about it because it is still at issue. In fact, the comments were just recently closed.

Senator BREAUX. Well, how about theoretically. Would it be consistent to have a price cap proposal and what it would do to competition along with a tariff 15, or would they be mutually exclusive, from a theory standpoint?

Mr. PATRICK. It is not inconsistent or unusual to have a generic approach to tariffing, and some tariffs that for whatever reasons are dealt with on a separate track.

We have proposed in general terms to exclude from price cap regulation long-term contracts, customized contracts—tariffs, I should say, although a tariff is a contract—or other tariffs that would not be subject to the positive incentive environment we think will be created by price caps.

We also propose to exclude tariffs where there is thought to be some potential for unique discrimination or cross-subsidy problems that we want to be extra careful about, and that is why we propose to exclude tariff 15.

Senator BREAUX. Thank you, Mr. Chairman.

Senator INOUYE. Thank you. Once again, I thank you very much, Chairman Patrick. I hope that we will be able to continue our discussions until your March 16th meeting, sir.

Mr. PATRICK. We certainly will, Mr. Chairman. Thank you.

Senator INOUYE. Thank you very much.

[Whereupon the hearing was adjourned at 11:05 a.m.]

[The following information was subsequently received for the record:]

QUESTIONS FROM SENATOR HOLLINGS
TO DENNIS PATRICK, CHAIRMAN OF THE FCC
March 1, 1989

Question 1: Last May, 1988, I wrote to you expressing my concerns with the FCC's treatment of several AT&T service contracts filed under Tariff 12. In your June 21st response you stated that

> The Bureau is devoting substantial staff resources to this task because we share your interest in concluding these investigations as expeditiously as possible, with our effort pointing toward the goal of releasing an Order no later than the end of this year.

a. Why were you not able to finish an investigation of any Tariff 12 filing before the end of last year?

Answer: The Tariff 12 investigation addresses more complex and fundamental questions of statutory interpretation and factual analysis than virtually any other tariff matter currently before this Commission. Although the Commission has made considerable progress in the Tariff 12 investigation since my June 21st letter to you, we were not able to complete our investigation as soon as we had hoped for a variety of reasons.

As you may be aware, Tariff 12 consists of a number of different filings representing variations in the mix and configuration of services provided to the customer. AT&T filed the most recent Tariff 12 filing only this past November. The investigation now covers five proposed offerings in addition to a petition for declaratory ruling filed by AT&T regarding the standards to be applied during the review of these offerings. The services themselves are complex, integrating many different common carrier functions into packages required by some of the most sophisticated telecommunications users in the country. The record alone consists of over a thousand pages of pleadings with many more pages of tariff revisions and cost support.

In my letter of June 21st, I indicated that the Common Carrier Bureau was devoting substantial staff resources to the investigation with the goal of completing the investigation and releasing an order by the end of 1988. While the investigation has taken longer than I had expected, we have continued to make resolution of this investigation one of our highest priorities and have devoted considerable resources to it.

b. When will you be able to release an order (or orders) finishing your investigations of the five contracts filed under Tariff 12?

Answer: The Commission will consider action on the core issues in the investigation at a special open meeting on April 4, 1989. After the Commission takes public action at that meeting, I will be able to discuss more fully the substantive aspects of our progress in the docket.

c. Do you anticipate that AT&T will file additional service contracts under Tariff 12 in the near future?

Answer: As you know, Congress established in the Communications Act a system of carrier-initiated tariffs. If AT&T chooses to file additional revisions to Tariff 12, it is free to do so and the Commission, under the statute, has no role to play in the timing of such filings. (American Telephone and Telegraph Company v. FCC, 487 F.2d 864 (2d Cir. 1973).) While there have been some press reports indicating that AT&T may file additional Tariff 12 offerings in the future, AT&T has not apprised the Commission of its plans in this regard.

Question 2: The FCC has also undertaken an investigation of AT&T's recent Tariff 15 filing. In beginning this investigation, the FCC stated that the tariff raised questions about its compliance with the Communications Act and the Commission's rules.

a. When do you anticipate that you will release an order finishing your investigation of Tariff 15?

Answer: The Commission plans to release an order terminating its investigation of Tariff 15 as soon as possible. We have given that investigation the highest priority. Some of the issues raised by Tariff 15 are related to issues under consideration in our Tariff 12 investigation and we expect that resolution of the latter will expedite our consideration of the former.

b. Do you anticipate that AT&T will make additional Tariff 15 filings in the near future?

Answer: As I note in my response to question 1.c., above, the Communications Act establishes a system of carrier-initiated rates. Thus, AT&T has the right to make additional Tariff 15 filings in the future if it chooses. AT&T has not apprised the Commission of its plans in this regard.

Question 3: In January, 1987, the Commission opened a rulemaking proceeding to consider, among other things, the regulatory treatment of services provided under contract by AT&T. In your letter of June 21, you stated that "the issues being debated are complex and do not lend themselves to easy or sure resolution".

a. Do you believe that there is any relation between the issues raised by AT&T's Tariff 15 and Tariff 12 filings and the issues raised in this rulemaking proceeding? If so, please explain the relation between this proceeding and these tariffs.

Answer: In CC Docket 86-421, the Commission released a Notice of Proposed Rulemaking in which it sought comment on whether to streamline the tariff review process for filings that implement contracts entered into by AT&T and a customer as the result of a competitive bidding process. The issues raised in CC Docket No. 86-421 are similar to some of the issues raised in the Tariff 12 and Tariff 15 investigations to the extent that some parties in the tariff investigations argue that the tariffs represent AT&T's responses to competitive bidding situations. Whether the tariffs can be so characterized is one of the many issues under consideration in the investigations.

b. Please explain in greater detail why the Commission has not moved forward on this rulemaking proceeding. What issues has the FCC been unable to resolve?

Answer: CC Docket 86-421 raises complex issues of law and economic analysis that would be difficult and time-consuming to resolve even if the Commission were operating with no constraints on its resources. In particular, that docket raised the concern that, given the perverse incentives created by rate-of-return regulation, dominant carriers would have strong incentives to shift costs improperly from streamlined to fully regulated services. Given this difficulty, the Commission devoted its resources to making progress on proceedings subject to statutory deadlines and on the price cap proceeding, which dealt more directly with the problem of harmonizing regulation of dominant carriers with the development of competition.

c. Do you expect to issue an order in this rulemaking proceeding before the end of this year?

Answer: Given the recent Commission decision adopting price cap regulation for AT&T and the significant changes in the marketplace for competitively bid services during the two years since the record closed in CC Docket 86-421, I would anticipate that any final order in that docket would require that the record be supplemented.

Question 4: In April, 1987, the Court of Appeals overturned the FCC's decision regarding the "special access" rates under Docket 20099 and ordered the Commission to require refunds of certain rates.

a. Why has the Commission been unable to order these refunds as the court required?

Answer: In Western Union Telegraph Company v. FCC, 815 F.2d 1495 (D.C.Cir. 1987), the court affirmed in part and reversed in part this Commission's decisions to abrogate the Docket 20099 Settlement Agreement. The 20099 Agreement had established the rates applicable to private line services obtained by AT&T's competitors from the integrated Bell System. The Court upheld our decision to abrogate the Agreement and affirmed our authority to prescribe transitional rate structures to avert rate shock. The court reversed, however, our conclusion that the notice provisions of the Agreement had been satisfied, and concluded that the Docket 20099 rates could not lawfully be increased prior to June 3, 1985. The court remanded the case to the Commission to calculate the appropriate monetary adjustment. The court also stated that this Commission "is free to reconsider what transitional rates would have been appropriate" in light of the Court's opinion. Western Union at 1505.

Implementation of the court's decision requires resolution of a variety of issues that are not evident from a cursory reading of the court's opinion. For example, the court invited the Commision to reconsider its transitional rate plan in light of the refund. Doing so raises questions not only with regard to the timing and substance of that plan, but also with regard to the various petitions for reconsideration and applications for review in the special access investigation docket (CC Docket 85-166) relating to the implementation of the rate transition plan. In addition, the refund liability of those BOCs who were members of the National Exchange Carrier Association's (NECA's) pool raises questions regarding the potential liability of the non-BOC pool members. Finally, the historical treatment of non-signatory OCCs under both the transition plan and the rates implementing the 20099 Agreement raises questions regarding their entitlement to the mandated refunds.

Accordingly, the Common Carrier Bureau released an order that, first, established procedures for obtaining the data required to order refunds:

- The order noted that the court's opinion requires a refund of special access charges above the rates established in the Agreement for circuits in place as of November 8, 1984, for the period from November 13, 1984, through June 3, 1985.

    -- For the period from November 13, 1984 through April 1, 1985, special access rates for these circuits were 20 percent higher than the Settlement Agreement rates, pursuant to Commission order.

-- For the period April 1, 1985 through June 3, 1985, special access rates for these circuits were 50 percent of the initial special access tariff rates.

- In addition, the court's decision requires refunds for OCC special access circuits that were added during the period from November 13, 1984, through June 3, 1985, of amounts paid in excess of the Settlement Agreement rates.

The Bureau directed the Bell Operating Companies (BOCs) to calculate and file with the Commission the appropriate refund amounts for their customers based on the orders received during the relevant period.

The Bureau order also established a comment cycle for parties who wished to address the court's invitation to the Commission to rethink its rate transition plan and to address the other issues raised by the refund.

In response to its order, the Commission received refund computations from the BOCs and comments from both the BOCs and Bell Communications Research (Bellcore) on the issues. Comments opposing the BOCs' refund calcuations and their substantive comments were filed by OCCs and trade associations.

Since the close of the pleading cycle, Bureau staff has been busy reviewing the record on all these issues and preparing a draft order addressing the arguments raised by all the comments on the various issues identified above.

b. When will the Commission issue an order that the refunds be paid?

Answer: Although Bureau staff involved with this project has been subject to turnover, the item has been given priority reassignment and we hope to act on it in the near future.

FCC Chairman Dennis R. Patrick's Responses to
Senator Daniel K. Inouye's Questions Following Up
On U.S. Senate Communications Subcommittee Hearing
On FCC Price Cap Proposal, March 1, 1989

Question 1: When did the official comment period end on this price cap docket? Since then, how many parties, including Members of Congress, have filed additional views or made ex parte presentations? Have any of these additional comments contained new information that affected your most recent proposal? Since you submitted your latest proposal to the Congress a short time ago, how many parties have made ex parte presentations on this proposal? Do you believe this extensive use of ex parte contacts, presenting new views and evidence, complies with the spirit of openness and equal opportunity for comment contained in the Administrative Procedures Act?

Answer: I believe that this Commission's consideration of ex parte presentations in the price cap proceeding has been fully consistent with the spirit, as well as the letter, of the Administrative Procedure Act (APA). The APA permits such presentations in notice-and-comment rulemaking proceedings such as our price cap proceeding. In order to ensure an adequate opportunity for others to respond to any new views and evidence submitted in such presentations, this Commission has gone beyond the requirements of the APA and required public notice of ex parte presentations. I believe that these procedures have been extremely beneficial to myself and to the public because they have allowed additional expressions of views about various price cap issues by Members of Congress and other interested parties outside the formal pleading cycle. This dialogue has resulted in improvements to my incentive regulation proposal in an environment of procedural openness and procedural fairness.

A review of the public notices of ex parte communications that were issued by the the Commission during the period from the close of the latest pleading cycle in the price caps docket on September 9, 1988, until March 1, 1989, shows that 92 notices of ex parte presentations have been filed with the Commission. This figure includes 17 ex parte presentations made since I began providing information about my revised price cap proposal to Congress in a letter to the Honorable Messrs. Dingell and Markey on January 19, 1989. These communications represent written and oral presentations made to me, to my colleagues Commissioners Quello and Dennis, and to various Commission staff members, and include correspondence received from Members of Congress about price caps.

The permissibility and the value of ex parte presentations in rulemaking proceedings such as the price cap docket are clear. The APA prohibits ex parte communications only in hearing adjudication cases; such communications are not prohibited in notice-and-comment rulemaking proceedings such as the

price cap proceeding.[1] As the United States Court of Appeals for the District of Columbia Circuit has held, Congress intended "not to prohibit or require disclosure of all ex parte contacts during or after the public comment period" in such rulemaking proceedings.[2] That Court also has recognized that in rulemaking proceedings "the importance to effective regulation of continuing contact with a regulated industry, other affected group, and the public cannot be underestimated."[3] In keeping with the APA and of congressional intent, the Commission's rules permit ex parte communications in notice-and-comment rulemakings other than those involving competing claims to a valuable privilege.

The Commission, however, in designing its ex parte rules, sought not only to comply with the letter of the APA but to "achieve fundamental fairness and a full record, while permitting the vigorous exchange of information necessary for reasoned and informed decision-making."[4] Thus, although not required by the APA, in order to ensure fairness to the parties, the Commission established a system for disclosure of ex parte communications in such proceedings.[5] In accordance with this system, Public Notices of ex parte communications are issued by the Commission. These Notices inform the public of ex parte communications and, thereby, give interested parties an opportunity to respond.

Thus, I believe that this Commission's consideration of ex parte presentations in the price cap proceeding has been fully consistent with the spirit, as well as the letter, of the Administrative Procedure Act (APA), and that this public dialogue with Members of Congress, as well as other interested parties, has permitted the Commission to improve the incentive regulation proposal set forth in our Further Notice of Proposed Rulemaking last May.

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1 5 U.S.C. {{ 554(d); 557(d). See also Action For Childrens' Television v. FCC, 564 F.2d 458 (D.C. Cir. 1977)(ACT); H.R. Rept. No. 880, 94th Cong., 2d Sess. (1976), reprinted in 1976 U.S. Code Cong. & Ad. News 2183, 2201. The courts also have imposed ex parte restrictions on rulemaking proceedings involving "competing claims to a valuable privilege," e.g., broadcast channel allotment proceedings. ACT, 564 F.2d at 477.

2 ACT, 564 F.2d 477; see also id. at 475 n.28.

3 Sierra Club v. Costle, 657 F.2d 298, 401 (D.C. Cir. 1981).

4 Amendment of Subpart H, Part 1 of the Commission's Rules and Regulations, 2 FCC Rcd 3011, on reconsideration, 2 FCC rcd 6053 (1987).

5 See 47 C.F.R. [1.1206.

Question 2: The promise of the Commission's price cap plan is that you will no longer regulate profits and only regulate prices. How can the Commission refrain from regulating profits when there is the 5th amendment requirements ensuring that the government does not confiscate telephone company property?

Answer: The price cap plan now under consideration does not represent an abandonment of cost-based regulation. The Commission would continue to look at costs and profits -- just in a different way than in our current rate-of-return system. Rather than focusing on profits, the Commission would regulate prices in the first instance. In so doing, we would create a more positive system of incentives that would redound to the benefit of consumers. I believe this approach to regulation would be fully consistent with the Commission's statutory mandate to ensure just and reasonable rates and with the 5th amendment's requirements concerning the confiscation of property.

The Communications Act requires telecommunications common carriers to charge just, reasonable, and non-discriminatory rates for their interstate services,[6] and requires this Commission to "execute and enforce [the Act's] provisions."[7] The statute does not compel us to employ rate of return regulation, or any other particular regulatory model, in carrying out our statutory mandate.[8] Indeed, the Supreme Court just this past January reaffirmed that "'no single method need be followed by the Commission in considering the justness and reasonableness of rates.'"[9] The

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6 47 U.S.C. {{ 201, 202.

7 47 U.S.C. { 151.

8 In both the Notice and the Further Notice we examined the legislative history of the Communications Act of 1934, and determined that in enacting the statute, Congress did not intend to compel a rate of return methodology. See Notice, 2 FCC Rcd at 5211 n.49; Further Notice, 3 FCC Rcd at 3296 n.346. As the Supreme Court has stated in connection with an analogous statute: "Congress, however, has provided no formula by which the 'just and reasonable' rate is to be determined.... It has not expressed in a specific rule the fixed principle of 'just and reasonable.'" FPC v. Hope Natural Gas, 320 U.S. 591, 600-01 (1944). Accord Duquesne Light Co. v. Barasch, No. 87-1160, slip op. at 15-16 (U.S. Jan. 11, 1989). None of the pleadings regarding the Further Notice cite any statutory or legislative authority that refutes our earlier analysis. In fact, the Subcommittee Staff Analysis does not appear to challenge this Commission's legal authority to depart from traditional rate of return regulation. See Subcommittee Staff Analysis at 25 n.78.

9 Duquesne Light Co. v. Barasch, slip op. at 16 (quoting FPC v. Texaco, 417 U.S. 380, 387-90 (1974)).

Court stressed that "circumstances may favor use of one rate making procedure over another. The designation of a single theory of rate making ... would unnecessarily foreclose alternatives which could benefit both consumers and investors."[10] To avoid this result, Congress provided this Commission with an array of regulatory powers, both specific and general, and broad discretion in determining how best to utilize them in the public interest.[11]

Our "broad discretion" extends to "'selecting methods ... to make and oversee rates ....'"[12] In reviewing ratemaking procedures under the Communications Act and under cognate statutes requiring just and reasonable rates, courts examine the end results of the regulatory schemes to determine whether they produce rates that fall within a "zone of reasonableness, "[13] the lower bound of which is set by the 5th amendment's concerning confiscation.[14] Although costs generally provide an important benchmark by which to evaluate rates,[15] the zone of reasonableness is not defined by a "'rigidly ... cost-based determination of rates, much less ... one that

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10 Duquesne Light Co. v. Barasch, slip op. at 16.

11 See, e.g., Western Union Int'l v. FCC, 804 F.2d 1280, 1292 (D.C. Cir. 1986)("The FCC's judgment about the best regulatory tools to employ in a particular situation is ... entitled to considerable deference from the generalist judiciary.").

12 MCI Telecommunications v. FCC, 675 F.2d 408, 413 (D.C. Cir. 1982)(quoting Aeronautical Radio v. FCC, 642 F.2d 1221, 1228 (D.C. Cir. 1980), cert. denied, 451 U.S. 920 (1981)). See Further Notice, 3 FCC Rcd at 3297.

13 See, e.g., FERC v. Pennzoil Producing, 439 U.S.508, 517 (1979); AT&T v. FCC, 836 F.2d 1386, 1390 (D.C. Cir. 1988)(quoting Jersey Cent. Power & Light v. FERC, 810 F.2d 1168, 1177 (D.C. Cir. 1987)). See also FPC v. Hope Natural Gas, 320 U.S. at 602 ("Under the statutory standard of 'just and reasonable' it is the result reached and not the method employed that is controlling."). Accord Duquesne Light Co. v. Barasch, slip op. at 10 (citations omitted)("Today we reaffirm these teachings of Hope Natural Gas: '[I]t is not theory but the impact of the rate order which counts.'").

14 FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 585-86 (1942).

15 Farmers Union Cent. Exch. v. FERC, 734 F.2d 1486, 1502 (D.C. Cir.), cert. denied, 469 U.S. 1034 (1984). See generally MCI Telecommunications v. FCC, 675 F.2d at 410.

bases each [carrier's] rates on his own costs.'"[16] Rates falling within the zone must simply be the product of a "reasonable balancing" between the "investor interest in maintaining financial integrity and access to capital markets and the consumer interest in being charged non-exploitative rates."[17] I believe that no commenter persuasively rebutted the Commission's tentative conclusion in the Further Notice that "ultimately, the substantive mandate under which we operate requires only that we select a ratemaking approach that is capable of keeping rates in the zone of reasonableness, or of detecting and correcting for the failure of market forces to do so."[18]

I tentatively believe that my current proposal falls within the parameters of the Commission's legal authority by ensuring just and reasonable rates in a cautious, evolutionary manner. For example, the plan's point of departure for establishing initial caps is a carrier's existing rates, which have been developed under rate of return regulation and which I believe represent an equitable and lawful point from which to launch the price cap system. Moreover, on a prospective basis, the plan's PCI adjustment formula is designed to reflect, for each basket of services, changes in both individual firm costs, and economy-wide and industry-wide costs.[19]

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16 FERC v. Pennzoil Producing, 439 U.S. at 517 (citation omitted); see also Permian Basin Area Rate Cases, 390 U.S. 747, 769, 797-98, 800-05, reh'g denied, Bass v. FPC, 392 U.S. 917 (1968)(upholding ratemaking based upon area-wide average costs); Farmers Union Cent. Exch. v. FERC, 734 F.2d at 1502-03(acknowledging agency authority to consider non-cost factors in establishing just and reasonable rates).

17 Jersey Cent. Power & Light v. FERC, 810 F.2d at 1177-78. See also FERC v. Pennzoil Producing, 439 U.S. at 517 (to fall within the zone of reasonableness, rates must be neither "less than compensatory" nor "excessive"); AT&T Information Systems v. FCC, No. 85-1198, slip op. at 3 (D.C. Cir. Aug. 30, 1988)(for rates to be just and reasonable "there must be 'a balancing of the investor and the consumer interests ...'").

18 Further Notice, 3 FCC Rcd at 3298 (citing Farmers Union Cent. Exch. v. FERC, 734 F.2d at 1509).

19 The PCI's firm-specific cost adjustments for changes in access costs and for specified regulation-induced cost changes are not different in principle from the treatment accorded those cost changes under rate of return regulation, except that the process of calculating those changes in the PCI is simplified by the use of historical weights rather than future demand projections. The adjustments for economy-wide and industry-wide cost changes reflected in the PCI's (GNP-PI - X) variable are similar in principle to the current treatment accorded average schedule

Most importantly, my price cap proposal cannot, and does not, allow carriers to earn excessive profits in light of their costs. The plan provides for continued monitoring of carrier cost and profit data, and, after three years, for a comprehensive review of their performance, which will include evaluation of the relationship between rates and costs. The Commission would stand ready to make any necessary adjustments to the PCI formula indicated by that monitoring or performance review. During the interim, the use of rate-of-return-generated existing rates to establish initial price caps, and the subsequent price cap adjustments made pursuant to the PCI formula should keep carrier profit levels in check. The price cap plan also retains tariff investigation and complaint proceedings under Sections 204 and 208 of the Communications Act, 47 U.S.C. {{ 204 and 208, which will continue to involve scrutiny of the nexus between carrier rates and their costs and profits.

To the extent that a price cap system is designed to permit greater earnings flexibility than a strict rate of return regime,[20] I believe that flexibility is lawful because the possibility of increasing earnings under incentive regulation drives companies to improve their efficiency, permitting lower rates for consumers than would otherwise exist.[21] Stated

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companies under rate of return regulation, and is also analogous to the Federal Power Commission's use of area-wide average natural gas producer costs in ratemaking, which the Supreme Court upheld in Permian Basin Area Rate Cases, 390 U.S. at 769, 797-98, 800-05.

20 As with ratemaking generally, as long as rates within the zone of reasonableness result, this Commission has broad discretion regarding the manner in which it deals with carrier profits. See generally Nader v. FCC, 520 F.2d 182 (D.C. Cir. 1975)(upholding Commission's decision to initiate a system of prescribing carrier rates of return); see also MCI Telecommunications v. FCC, 675 F.2d at 416 (upholding this Commission's adoption of an Interim Cost Allocation Manual for AT&T, under which AT&T would not necessarily be compelled to earn the same rate of return for each service). In addition, we observe that any ratemaking methodology that utilizes costs that are not firm-specific necessarily allows carriers to improve profits by reducing their costs below the benchmark set by the regulator. Such a result is implicit in the area-wide ratemaking scheme upheld in Permian Basin Area Rate Cases, 390 U.S. 747, as well as the rate-making methodology this Commission currently uses with respect to average schedule companies. See City of Brookings Mun. Tel. v. FCC, 822 F.2d 1153 (D.C. Cir. 1987); NARUC v. FCC, 737 F.2d 1095, 1127-29 (D.C. Cir. 1984), cert. denied, 469 U.S. 1227 (198_).

21 Our attempt to harness this incentive in a manner that advances the public interest is not novel. In addition to the reform programs underway

another way, rates resulting in somewhat higher profits may remain just and reasonable in the context of a regulatory regime that encourages carriers to become more efficient and to lower costs, with consumer benefits assured in the form of lower rates that would not otherwise have been achieved.[22]

Thus, I believe that this approach to rate regulation is fully consistent with the Commission's statutory mandate to ensure just and reasonable rates, and with the 5th amendment.

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in various states and in Britain (see Further Notice, 3 FCC Rcd at 3229-3240 (paras. 57-81)), other federal agencies have premised ratemaking procedures on the assumption that carriers will attempt to improve efficiency if given the opportunity to tenefit from such improvement. See, e.g., Associated Gas Distributors v. FERC, 824 F.2d 981, 1007 (D.C. Cir. 1987), cert. denied, 108 S.Ct. 1468, 1469 (1988).

22 Agencies have the authority to adopt incentive-based regulatory approaches to rate regulation if the public interest is served thereby. The Supreme Court, for example, has upheld a Federal Power Commission incentive plan that permitted an increase in rates in order to encourage increased production. Mobil Oil Corp. v. FPC, 417 U.S. 283 (1974). In doing so, the Court emphasized that it was permissible for the agency to consider non-cost factors:

> Mobil's argument assumes that there is only one just and reasonable rate possible for each vintage of gas, and that this rate must be based entirely on some concept of cost plus a reasonable rate of return. We rejected this argument in Permian Basin and we reject it again here. The Commission explicitly based its additional "non-cost" incentives on the evidence of a need for increased supplies.

Id. at 316. See also Public Service Comm'n of New York v. FERC, 589 F.2d 542, 559 (D.C. Cir. 1978).

Question 3: Do you believe the Commission must permit a breach of the price cap if a carrier demonstrates that it is not earning a sufficient return on its investment?

Answer: Under price caps, as under rate of return, consumers and carriers have a right to rates that fall within a zone of reasonableness, a zone that reflects a balancing of investor and consumer interests. If a carrier were able to demonstrate that rates are below that zone of reasonableness under any regulatory system, the Commission would have to permit that carrier to increase its rates. Similarly, if the Commission found that rates were above the zone of reasonableness, it would require a rate reduction. I believe that it is extremely unlikely that a carrier would be able to demonstrate that rates in compliance with our price cap would fall below the zone of reasonableness, and thus require us to permit the carrier to breach the price cap.

In order to allay any concerns you may have on this point, I want to take this opportunity to discuss this issue in greater detail. In its May 1988 Further Notice in the price cap proceeding, the Commission tentatively found that tariffs proposing above-cap rates would be filed on 90 days' notice, would generally be suspended, and would be required to be accompanied by cost support demonstrating that the rates were just and reasonable. We stated that the cost showing would include cost data for each element in the relevant basket for the most recent four years under price cap regulation, as well as a detailed explanation of the carriers' method of allocating costs among the rate elements. We deemed this extensive showing necessary to allow a determination that the costs driving the increase had been prudently incurred and that the increase was just and reasonable.[23] With minor modifications, I currently believe the Commission should adopt our proposal from the Further Notice to require a full cost-based showing for filings proposing above-cap rates.

I believe that the showing I am proposing for above-cap rates would be less flexible and more difficult than the showings currently required of AT&T under rate of return. This is for good reason. The proposed price caps scheme would grant AT&T significant new flexibility below the cap. The determination that below-cap rates are presumptively just and reasonable would require the Commission to look very closely at all above-cap filings. Furthermore, because the purpose of price caps is to create incentives to reduce costs, consistent with rates falling within the zone of reasonableness,

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23 E.g., that the increase is necessary to avoid confiscation or to ensure acceptable service quality. Further Notice, 3 FCC Rcd at 3375 (para. 319).

I believe that we must choose a method of handling tariffs proposing above-cap rates that preserves those incentives. If the Commission did not examine the cost/price relationships for all services in the basket for which the carrier proposes to exceed the cap, and if we did not inquire into the investment and marketing decisions that led to the above-cap filing, then we would indeed be vulnerable to the criticisms put forth by commenters that the above-cap showing would make it easy for AT&T to violate the price cap.

The showing I propose to require would be extensive and complex and would restrain AT&T from exceeding the cap at will. It would take AT&T some time to develop such a showing. Once filed, it would be virtually certain that the Commission would require a full 90-day notice period and would suspend the tariff for an additional five months, the maximum time allowed by the Act. Such a filing would be evaluated extremely carefully, in the light of a strong presumption that within-cap rates would be just and reasonable. I do not anticipate that above-cap rates would be routinely filed or granted, as the burden on AT&T would be greater than under existing procedures or under the substantial cause test. In any event, under the proposed procedures, considerable time would elapse between the time AT&T decided it wanted an above-cap rate and the time such a rate went into effect, if at all. AT&T would not be able to simply switch from price caps back to cost-based regulation. A rational assessment of the possibilities should lead AT&T to the conclusion that an above-cap filing, while permissible, is risky and that the best way to assure continuous profitability is to whole-heartedly pursue the efficiency incentives held out by the price caps program.

While AT&T must be given a fair opportunity to justify any above-cap rates, the difficulty of the showing that AT&T would have to make under my proposal is reasonable in light of the flexibility given to AT&T with respect to below-cap rates. Moreover, it is quite unlikely that, within the next four years, the formula would stray so far from actual costs that the cap would produce unreasonably low rates. The proposed price cap plan begins with existing, carrier-initiated rates; if those rates were not currently high enough, AT&T has had an opportunity to propose rate increases. The proposal also would allow those rates to move with inflation and with changes in access charges and other exogenous costs. The flow-through of access charges alone means that AT&T would be guaranteed rates reflecting all increases in its single largest expense. The productivity adjustment is well within the various estimates of the long-term productivity of the industry; with the addition of the CPD, it represents a productivity goal which I believe AT&T can and will exceed.

I also tentatively believe that we should recognize that not every rate element can be assigned a cost. As AT&T notes, one cannot assign costs as between the fixed and usage-based elements of the charges for a service like PRO America. On the other hand, when AT&T originally filed the tariffs for its services it had to demonstrate that the rate structures it proposed would recover the costs of the service. It may not be possible to assign discrete costs to each rate element of each service, but it should be possible to demonstrate how the pricing of each rate element is related to the cost of the service. In making a showing for an above-cap tariff, therefore, I currently believe we should require AT&T to assign costs down to the lowest possible level, and to make a detailed explanation of the reasons for the prices of all rate elements to which it does not assign costs.

I tentatively believe one further modification to our proposal is needed. We said in the Further Notice that the allocation of costs within the basket would have to be explained. Upon further consideration, however, it is apparent to me that we will also need an explanation of the manner in which AT&T has allocated costs among baskets if the Commission is to properly evaluate an above-cap filing. Otherwise, if we consider an above-cap filing for one basket without looking at the other baskets, the baskets would not perform their intended function of reducing the likelihood of cross-subsidy between less- and more-competitive services.

Question 4: In the Commission's previous price cap proposals, it rejected such mechanisms as a refund mechanism for excess profits and frequent review of the price cap index, stating that they would "replicate a flaw of rate-of-return regulation." Yet, you are now proposing these mechanisms as part of the price cap plan for the local telephone companies. Since the Commission has already admitted that these mechanisms make price caps virtually indistinguishable from rate of return regulation, why go ahead with adopting price caps for the local telephone companies?

Answer: In the May 1988 Further Notice, the Commission tentatively concluded that application of price caps to local exchange carriers (LECs) would further the public interest because it is in markets served by LECs that the distorted incentives rate-of-return regulation creates are the least offset by competitive market forces and, therefore, that the benefits of price caps are likely to be greatest. After reviewing the record in detail, I am aware of no new, persuasive evidence that would warrant a reconsideration of this tentative conclusion, and I will urge the Commission to reaffirm it.

I also agree wholeheartedly with the counsel I received at the Senate and House hearings last week that the Commission, in designing a price cap system, should err on the side of consumers. Indeed, during the initial implementation period of any new form of regulation, it is prudent to err in the direction of including safeguards to protect both ratepayers and shareholders. With regard to price caps specifically, the record reflects somewhat greater uncertainty associated with the calculation of a LEC productivity factor than with calculating a productivity factor for AT&T, which has caused me to propose consideration of an additional backstop in the LEC price cap plan that would help ensure the plan results in just and reasonable rates for LEC interstate services.

An "automatic stabilizer" could serve as such a backstop. As I have discussed in previous correspondence with you, such a mechanism could be used to adjust a LEC's price cap index prospectively based on deviations of that LEC's actual rate of return from a specific range. As your question suggests, the application of such a mechanism would dampen at a certain level of achieved productivity the efficiency- and consumer-oriented incentives that price cap regulation is intended to generate. For this very reason, as an alternative to the stabilizer, I will urge my colleagues to seek comment on the possibility of conducting a review of price caps more quickly than the comprehensive review proposed in the Further Notice. Such a review could serve the same safeguard role as a stabilizer, and serve just as effectively, without impairing the positive incentives noted above.

I respectfully disagree with the suggestion that the Commission tentatively has concluded that the addition of one of these backstops would make price caps virtually indistinguishable from rate of return regulation. Indeed, in the Further Notice, the Commission, in reviewing the experience of the numerous states that have adopted some form of incentive regulation, commented favorably upon one state plan that includes a mechanism similar to an automatic stabilizer. It characterized the plan as a variation of the price cap approach, categorized the plan along with the British plan that my own proposal resembles most closely, and stated that both the state and British plans "represent innovative attempts to offset the limitations of traditional rate-of-return regulation."[24]

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24 Further Notice, 3 FCC Rcd at 3240.

Question 5: I have had some interested parties argue to me that if the Commission adopted price caps for AT&T and not for the local telephone companies, severe problems would result. Do you agree with this?

Answer: Based on the record in this proceeding, the Commission's long experience with rate-of-return regulation, and the experience of many of the states and Great Britain with new incentive programs, I am recommending to my fellow Commissioners that we should conclude that we should replace rate-of-return regulation for the local exchange carriers (LECs) with incentive regulation. As with AT&T, I believe that incentive regulation will improve LEC incentives to cut unnecessary costs and to offer new and innovative services at reasonable prices. Indeed, I believe that these potential gains for consumers may prove to be larger for the LECs than for AT&T because the LECs have, in general, been less subject to the discipline of competition than has AT&T. Moreover, because the LECs comprise a large majority of the domestic telecommunications industry, and because LEC-provided access constitutes approximately half of AT&T's interstate costs, I believe it is important to implement incentive regulation for these carriers quickly to ensure the greatest public benefit.

This does not mean, however, that we should delay incentive regulation for AT&T pending resolution of the remaining implementation issues associated with the LECs. Some of the LECs have argued that application of price caps to AT&T, but not to them, would lead to bypass of the public switched network as AT&T attempted to cut its access costs. Bypass has been a significant policy concern of the Commission for some years, and remains so. Despite specific requests for comment on the issue, however, I do not believe that the record contains any detailed or convincing arguments that the asymmetrical application of price caps would increase the risk of bypass. It is, for instance, not obvious that AT&T's bypass incentives under incentive regulation would be any greater if the LECs were not also subject to incentive regulation. Bypass incentives would be particularly attenuated if price cap implementation for the LECs were delayed for just a short period, as I currently propose, since the decision to engage in bypass often requires long-term financial commitments that would be imprudent if made only to secure short-term price savings.

Question 6: In your recent submission, you provided a model developed by your staff demonstrating that if price caps were adopted for AT&T, ratepayers would be better off by about $900 million over four years. This model, however, did not demonstrate how AT&T's share holders would fare. How much better off would they be?

Answer: In the May 1988 Further Notice, the Commission tentatively concluded that during the post-divestiture period AT&T has achieved approximately 2.5 percent productivity gain each year relative to the economy as a whole. Therefore, in order to ensure that consumers are better off under price caps, the Commission tentatively has determined that AT&T's rates should be adjusted downward each year by 3 percent. This includes the 2.5 percent level of historic productivity plus an additional benefit of 0.5 percent that we refer to as the Consumer Productivity Dividend (CPD). As noted in your question, the computer model developed at your request illustrates that, if price caps are adopted for AT&T, ratepayers will be better off by approximately $900 million over four years than they would have been if rate of return regulation were continued, with $700 million of this amount going to residential ratepayers.

A review of data received in response to the Further Notice indicates that AT&T's annual productivity level during the post-divestiture period actually was somewhat lower than 2.5 percent. However, I continue to advocate the use of a 3 percent productivity factor in the formula that would be used to adjust AT&T's rates under price caps.

It is important to note that, even though AT&T has been achieving 2.3 percent annual productivity gains during the post-divestiture period, it has not achieved its authorized level of return on investment during any year since divestiture. The results of the Commission's monitoring of AT&T's returns during this period -- monitoring that would be continued if price caps are adopted -- confirm this statement. From 1984 through 1986, a period in which AT&T's was authorized to earn 12.75 percent on its investment, AT&T reported the following annual returns: 10.2 percent in 1984; 11.84 percent in 1985; 11.31 percent in 1986. Since January 1987, AT&T has been authorized to earn 12.2 percent on its investment. For the period beginning January 1, 1987, and ending June 30, 1988, AT&T earned an annualized return of 10.17 percent on its public switched services and 10.75 percent on its private line services.

The precise level of productivity AT&T may achieve under price caps depends upon the degree of success AT&T obtains through its attempts to become more efficient and to respond to consumer demand. Experience in the telecommunications industry and other industries indicates that productivity advances over the long-term are almost certain to be incremental in nature, as opposed to increasing by orders of magnitude. There is no evidence in the record, nor any reason to anticipate, that AT&T would be able to achieve anything other than the steady accumulation of modest productivity gains.

Against this background, it is possible to make some reasonable estimates of AT&T's potential productivity achievements under price caps. If AT&T achieves the same 2.3 percent annual productivity gain it has achieved in the recent past, then it likely will realize a return on its investment of approximately 11 percent. If it achieves a 3 percent level of productivity, it will realize a return on investment at approximately its currently authorized level of 12.2 percent.

Put simply, the application of the 3 percent productivity mark to AT&T's rates means that AT&T must maintain a level of productivity that is slightly more than 20 percent higher than it has achieved historically, just in order to obtain earnings at the currently authorized level.

It is possible that AT&T may be able to increase its productivity by a full percentage point under price caps -- raising its historically achieved productivity level from 2.5 to 3.5 percent annually (a 40 percent increase). Under my proposal, the benefit of this increase would be divided equally with consumers. Application of the CPD would give consumers 50 percent of this increased productivity, and AT&T would retain the benefit of the remaining 50 percent. The Common Carrier Bureau estimates that, under this scenario, AT&T would achieve an earnings level in the range of 13 -to- 13 and one half percent return on investment.

Although it is unlikely that AT&T would be able to increase its productivity by more than a full percentage point, in the long-run, this result should be welcomed, not a cause for concern. If AT&T actually does improve its productivity -- revealing to the public that it can be more productive than it historically has been under rate of return regulation -- the benefit of this improvement will flow to ratepayers in the long run because this information will be used during the comprehensive review of caps to benefit ratepayers, such as by adjusting AT&T's productivity factor upward, just as the British government did with its dominant carrier, British Telecom, after a few years of experience with price cap regulation in the United Kingdon. Equally important in my view, my proposal is structured to ensure that consumers receive lower rates under price caps than history indicates they would receive under rate of return regulation whether AT&T improves its productivity or not.

Question 7: The key reason for the savings demonstrated in your model is the productivity index you have chosen, yet you concede this was based on some rough justice. Since this index is so important, why doesn't the government develop one?

Answer: Although the Commission will carefully consider any telecommunications-specific productivity index that the Department of Labor's Bureau of Labor Statistics (BLS) is able to develop in the future, I believe that delaying implementation of price cap regulation until we could complete that consideration would unnecessarily postpone the consumer benefits of price cap regulation.

I propose to adopt a price cap productivity target for AT&T based upon an analysis of long-term Bell System productivity studies, as corroborated by the Common Carrier Bureau's own study of AT&T's post-divestiture productivity. After review of the extensive comment received in response to the Further Notice on possible alternative methodologies for setting our productivity factor, I believe that long-term productivity numbers should generally bear a closer relationship to the level of productivity in the future than will contemporary efforts of prediction, and thus rely most heavily on those studies. I also believe that it is appropriate to make some accommodation to reflect recent AT&T productivity, as set forth in the Bureau's own study, which indicates that AT&T's productivity gains were 2.3% greater than economy-wide gains from 1984 to 1988. These studies provide ample support for my conservative proposal to set 2.5% as the productivity factor reflecting gains that AT&T would achieve if we continued our current rate-of-return system. In my view, these studies provide a reasoned and reasonable basis for implementing price cap regulation so as to ensure that ratepayers are better off than they would be under continued rate-of-return regulation.

In light of this extensive record, I do not believe that the success of price caps requires that the U.S. Government develop a new productivity index for the telecommunications industry. I realize that the BLS has for some time been attempting to develop such an index without apparent success. My understanding is that the BLS has not been able to complete its work to date due to difficulties in data collection, and that it is not clear when the index currently under development will be established. I would, of course, give careful attention to such an index, once it became operational, to determine its fitness for use in the price cap context.

In light of this uncertainty regarding the BLS index and my confidence in the Commission staff's analysis of historical carrier productivity, especially long-term productivity, I do not believe it is in the public interest to delay the benefits of incentive regulation until a telecommunications-specific productivity index is completed.

Question 8: You often refer to the states as having led the way on incentive regulation. Have you surveyed the states to determine the productivity factors they are using?

Answer: The states have indeed led the way on incentive regulation, experimenting with many different kinds of regulatory reform. The extensive record developed in the course of our price cap proceeding provides a detailed picture of the recent changes made by state regulators. A number of them have introduced alternative regulatory methodologies with features not unlike my proposal for incentive regulation.[25] Banded rate plans, streamlined review, as well as rate "freezes" dominate the state regulatory landscape. Some of these plans have set no cap on price increases for services subject to a sufficient degree of competition. Others have set ceilings on rate increases for certain services, while still others have established various forms of "freezes" on existing rates. I am not aware of any state plan that has required a ratcheting down of a price ceiling based on the requirement that a regulated firm achieve productivity gains over and above those experienced by the economy as a whole, as does my proposal.

The record developed in our price cap proceeding provides an extensive amount of detail on state regulatory reforms. The Further Notice, for example, described in detail the rate moratorium plan currently in effect in New York State for New York Telephone.[26] As the Commission has stated, the sheer number of incentive-based experiments currently under way in the states is testimony to the limitations of rate-of-return regulation for the telecommunications industry.[27]

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25 In its comments, AT&T identifies 17 states that have ended rate of return regulation for it: Florida, Georgia, Idaho, Illinois, Maryland, Minnesota, Nebraska, New Jersey, Nevada, Oklahoma, Oregon, Pennsylvania, South Carolina, South Dakota, Virginia, Washington, and West Virginia. AT&T Comments at 2, n.**. On October 26, 1988, Colorado also moved to an incentive-based system of regulation of AT&T. See Application of AT&T Communications of the Mountain States, Inc. for Relaxed Regulation of Certain Emerging Competitive Telecommunications Services, Decision No.C88-1467, October 26, 1988.

26 Further Notice, 3 FCC Rcd at 3236-40 (paras. 71-81). Similar plans have been introduced for LECs in Connecticut, Alabama, and Wisconsin.

27 In addition to the 18 states that have removed rate of return regulation for AT&T, 12 other states have introduced reduced rate of return regulation for AT&T and have granted increased pricing flexibility: Arizona, Kansas, Michigan, Mississippi, Missouri, Montana, North Carolina, New York, Ohio, Tennessee, Texas, and Wisconsin. As a result, 30 of the 42 states for which AT&T provides intrastate toll services have moved away from or abandoned the form of regulation the Commission currently employs in regulating AT&T.

For example, of those states that have moved away from rate of return regulation for AT&T, most provide for pricing flexibility[28] with reduced notice periods for rate changes.[29] Most states do not attempt to measure AT&T's intrastate profitability under the various regulatory reforms,[30] although some require financial reporting that reflects total company earnings[31] or other monitoring of AT&T performance.[32] These

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States have also begun to introduce reform in their regulation of LECs. In addition to those states employing a profit-sharing mechanism like New York's, states such as Ohio, Maryland, New Jersey, and West Virginia have introduced additional flexibility or streamlining into their rate of return regulation of LECs.

28 Full pricing flexibility for AT&T is provided in Virginia, Oklahoma (on an interim basis), Illinois, West Virginia, Minnesota, and Washington. Prices may move within a specified range in Oregon, Nevada, Pennsylvania, South Carolina, Florida, and Colorado. New Jersey capped existing MTS rates for one year during 1988, after relaxing rate of return regulation in 1985.

29 Virginia (10 days' notice for all services); Oregon (30 days' notice for increases, one day for decreases); Nevada (10 days' notice if within a specified range); Oklahoma (30 days' notice); Pennsylvania (30 days' notice); Illinois (30 days' notice for increases, one day for decreases); West Virginia (14 days' notice); Maryland (14 days' notice); Nebraska (one day to reduce rates up to 50 percent, one day to increase access or billing charges); South Carolina (14 days' notice for rates below a ceiling); Minnesota (30 days' notice for increases, 10 days for decreases); Washington (10 days' notice); New Jersey (14 days' notice for increases below a ceiling, 5 days' notice for decreases); South Dakota (20 days' notice); Idaho (10 days' notice); Georgia (14 days' notice for rates below a ceiling); Florida (30 days' notice for rates within a specified zone); Colorado (14 days' notice for MTS within a specified zone and 14 days' notice for WATS/800 and Megacom).

30 Virginia, Oregon, Nevada, Oklahoma, Illinois, West Virginia, Nebraska, South Carolina, Washington, New Jersey, Idaho, and Georgia do not track intrastate profits. But see Pennsylvania (reviews AT&T's operating ratio and applies a comparable earnings test); Maryland (reviews operating margin quarterly); and Florida (reviews quarterly rate of return reports).

31 Virginia (annual report and quarterly revenue reports); Nevada (semi-annual report on intrastate revenues, annual report, 10K report to SEC); Oklahoma (annual report); Pennsylvania (annual report, abbreviated income statement); Illinois (Form M annual report, total telecommunications plant in service and total operating revenues); West Virginia (annual report); Maryland (income statement for intrastate long distance, quarterly

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regulatory reforms for AT&T at the state level began shortly after divestiture and continue today.[33] A recent study conducted by Federal Trade Commission staff of states that have applied an incentive-type approach to the regulation of AT&T's Message Telecommunications Service (MTS) rates demonstrated that prices are on average between 7 and 10 percent lower in reform states than in those that use traditional rate of return.[34] Furthermore, many states are actively pursuing reform of their regulation of the LECs.[35]

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rate base reports, quarterly analysis of margin, total minutes of use and total revenue on a quarterly basis); Nebraska (annual report); South Carolina (quarterly surveillance reports, annual reports, Form M for AT&T of the Southern States); Washington (annual financial and affiliated interest reports); Florida (quarterly surveillance reports, annual reports, analysis of margin between rate ceilings and rate levels); Colorado (annual report).

32 Virginia (monitors price levels, financial condition, complaints, held orders for other IXCs, competitive activities); Nevada; Nebraska (annual reports from commission to legislature); Minnesota (commision may require information on revenues, expenses, costs, and investments); Washington (annual reports to the legislature); Georgia (maintain records in accordance with the USOA, and furnish reports as required by the Commission); Florida (two-year trial to end with review of number of factors); Colorado (quarterly reporting of revenues, expenses, investment, numbers of customers, calls, minutes of use, trunks, rate of growth or estimate of growth, records of customers who switch services).

33 Virginia adopted its decision to abandon rate of return for AT&T in August 1984, followed by Oregon in December 1984. Nevada, Oklahoma, and Pennsylvania followed suit in 1985. In 1986, the states of Illinois, West Virginia, and Maryland decided to abandon rate of return for AT&T, followed by Nebraska, South Carolina, Minnesota, Washington, and New Jersey (for MTS) in 1987. This year, South Dakota, Idaho, Georgia, Florida, and Colorado have moved away from rate of return regulation for AT&T.

34 A. Mathios & R. Rogers, "The Impact of Alternative Forms of State Regulation of AT&T on Direct Dial Long Distance Telephone Rates," Federal Trade Commission, Bureau of Economics, Working Paper Series No. 159 (Dec. 1987).

35 Those states currently studying reform include: Illinois, Michigan, Iowa, Indiana, the District of Columbia, Massachusetts, Vermont, Virginia, Florida, California, Nevada, Oregon, and Washington.

Although the states have not employed a productivity factor to ratchet down a price cap, the regulatory system employed in the United Kingdom to regulate British Telecom does include such a factor. After years as a part of the U.K. Government, British Telecom was privatized in 1984. To regulate the new firm, the Government adopted a price cap plan, requiring British Telecom to improve its productivity relative to the economy by 3 percent annually. Under that regime, the weighted prices for British Telecom's services increased by only 5.5 percent over a time period when the United Kingdom's overall inflation rate rose by 20.1 percent.[36] Within the past year, our regulatory counterparts in the United Kingdom, the Office of Telecommunications (Oftel), have completed their initial review of their incentive-based system.[37] Because Oftel found that, under price caps, British Telecom had increased its productivity to a significant degree, Oftel decided to retain the price cap system, and to revise the carrier's annual productivity target to 4.5 percent.[38] By this adjustment of the productivity target, British consumers will benefit directly from British Telecom's efficiency gains spurred during the initial period of price cap regulation.

There are significant differences in the economic conditions facing British Telecom and American carriers, and I therefore do not propose to initiate price cap regulation in this country with a 4.5 percent productivity offset. The long term Bell System productivity studies that I have reviewed, as well as the Commission staff's analysis of AT&T's post-divestiture productivity, suggest that my proposed 3.0 percent productivity factor will be an ambitious one during the initial stages of incentive regulation. Nevertheless, it is my hope that price cap regulation will spur the improved productivity here that it has in Britain, and I would not hesitate to recommend a higher productivity factor if, upon comprehensive review after three years, such an adjustment were appropriate.

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36 Further Notice, 3 FCC Rcd at 3239 (para. 80).

37 "The Control of British Telecom's Prices," Oftel Statement, released July 7, 1988.

38 Id. at 20 (proposing to change the productivity offset from 3 percent to 4.5 percent).

Question 9: Often when states have adopted incentive regulation plans, they have required a reevaluation of rates. Why hasn't the Commission required such a reevaluation?

Answer: For a number of reasons, including the reevaluation of nearly all of AT&T's existing rates conducted by the Common Carrier Bureau during the past year in tariff investigations, I currently believe that reliance on AT&T's existing rates is the most reasonable option for initially determining compliance with the price cap system. In reaching this determination, I have carefully considered the possibility that AT&T's existing rates lie outside the zone of reasonableness or, if within the zone for rate of return purposes, warrant "correction" prior to initiating a price cap regime. I have evaluated AT&T's existing earnings and the possibility that particular rates are unjust or unreasonable. I have also considered how the price cap mechanisms I propose to adopt will influence rates in the future. For the reasons described below, I believe that use of AT&T's existing rates as a starting point will not operate to the detriment of ratepayers now or in the future, as some commenters argue. I also believe at this time that the use of AT&T's existing rates as a starting point is appropriate because nearly all of these rates have been scrutinized by the Common Carrier Bureau during the past year.

Some parties argue that existing rates are "too high," and therefore should not be used to initiate price caps. If these parties mean that rates are "too high" in an economic sense, because they have been developed inefficiently, I agree. However, existing rates are not too high as a legal matter; if existing rates were not based on costs incurred in a rate of return environment, we would have required AT&T to lower them. Moreover, AT&T is underearning for the two-year reporting period established in our rate of return proceeding. AT&T is also underearning on an overall basis for the first nine months of 1988, and is earning less than its allowable rate of return in both its public switched and private line categories for that period.[39] Thus, for each of these aggregate service categories,

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39 See Form 492 for AT&T, filed December 30, 1988. AT&T's actual rate of return has not exceeded its authorized rate of return in any year since divestiture. From 1984 to 1986, AT&T's authorized rate of return was 12.75 percent. See Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, CC Docket No. 84-800, Report and Order, FCC 85-327 (released Sept. 30, 1985) at para. 4. AT&T earned 10.2 percent in 1984, 11.84 percent in 1985, and 11.31 percent in 1986. See AT&T Interstate Monthly Reports for December 1984, December 1985, and December 1986. Since January, 1987, AT&T's authorized rate of return has been 12.2 percent. Authorized Rate of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, CC Docket No. 84-800, Memorandum Opinion and Order, 51 Fed. Reg. 32,920 (Sept. 17, 1986). For 1987, AT&T earned 8.61 percent in the public switched category, and 8.67 percent in the private line category. See AT&T's Form 492, filed March 31,

AT&T's rates appear to be within the zone of reasonableness. The fact that AT&T's reported rate of return is below the legal limit strongly suggests to me that AT&T's rates are not too high, given the costs attributed to the service categories. As to individual rates, the Common Carrier Bureau has recently concluded investigations of nearly all of AT&T's existing rates, including a full scale investigation of AT&T's rates effective January 1, 1988, and AT&T's private line rate structure.[40] The Commission also recently completed an investigation of AT&T's 56 kbps switched digital services.[41] We determined that these rates are not unlawful. I also note that many of AT&T's existing rates were set in the context of competitive pressures from other carriers, which contributes to the reasonableness of using them as a starting point for price cap regulation.[42]

I am not proposing that we adjust existing rates before initiating price cap regulation. Some parties would have us require a rate case before initation of price caps, thereby implicitly requesting assurance that every service earns precisely the authorized rate of return. I do not believe

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1988. Under my proposal, the Commission would, of course, continue to monitor AT&T's actual rate of return for 1988 and 1989, up until the time price cap regulation is implemented.

40 AT&T Communications, Revision to Tariff F.C.C. Nos. 1, 2, 11, 13, and 14, 3 FCC Rcd 3617 (1988); AT&T Communications, Revisions to Tariff F.C.C. Nos. 1, 2, 11, 13 and 14, Transmittal Nos. 1063 and 1064, CC Docket No. 87-611, Memorandum Opinion and Order, DA 88-1707 (released Nov. 1, 1988); AT&T Communications Tariff F.C.C. Nos. 9, 10, and 11, Transmittal Nos. 285, 318, 342, 346, 504, and 559, CC Docket No. 85-400, 3 FCC Rcd 4579 (1988).

41 AT&T Communications, Tariff F.C.C. Nos. 4 and 10, Transmittal No. 311, Memorandum Opinion and Order, 3 FCC Rcd 5929 (1988).

42 To the extent that parties arguing that existing rates are too high in the economic sense contend that the initiation of price caps with existing rates will permit AT&T a windfall, I tentatively disagree. This argument assumes that AT&T can reduce its costs instantaneously and recoup the difference between regulatory and economic costs. While I expect that price cap regulation will provide incentives to be more efficient, I would not expect these efficiencies to be realized immediately, but rather, over a span of years. It is apparent that AT&T would not be able to reduce its rate base immediately, and it may also take some time before AT&T has significantly reduced its expenses. There is a recognition in the economic literature that impediments to adjustment of expenses exist and take some time to overcome. See, e.g., Scherer, Industrial Market Structure and Economic Performance 31-32 (1980); K. Cohen and R. Cyert, Theory of the Firm 334 (1965).

that a rate case, however streamlined or truncated, would serve the public interest. As an initial matter, since AT&T is presently underearning in the aggregate, a rate case would logically result in an increase in aggregate rates, despite AT&T's willingness to employ existing rates as a starting position. The additional flexibility provided by a higher set of rates would appear to run counter to the objectives of the critics of existing rates. Furthermore, a rate case demands that regulators employ a cost allocation methodology so that joint and common costs incurred in the provision of common carrier service are reflected in some systematic way in the measurement of service costs. But cost allocation standards imposed by regulators, such as the fully distributed costing methodology we have employed in such situations, will simply produce a set of rates that is dictated by the costing methodology employed.[43] Thus, the rates that would be derived in the course of a rate case would not necessarily be driven by economic efficiency; they would more likely reflect a cost allocation decision imposed by regulators.

In addition, it is not clear that a rate investigation of the scope contemplated by the parties could be completed expeditiously. As a result, a rate case would either substantially delay caps or, if expedited, would not produce results that are significantly dissimilar from existing rates.[44] Thus a rate case, in my judgment, would be an administratively burdensome, and possibly time consuming process, with no guarantee of results that are substantially different from (let alone lower than) existing rates. As an alternative to a rate case, some parties propose that rates be reduced by a fixed percentage in order to squeeze out unnecessary investment and expenses occurring under rate of return regulation. The Commission tentatively proposed in the alternative that such a mechanism be applied to LEC rates, but not to AT&T rates.[45] In my view, commenters have not substantiated their assertions that such an adjustment should be applied to AT&T. Indeed, an across-the-board reduction is not a satisfactory substitute for a rate case, since there is no evidence that a comprehensive examination of AT&T's rates is likely to produce a 2-3 percent price cut.

Thus, one weakness of rate of return regulation is that it permits rates to be too high in an economic sense, but reasonable in a legal sense.

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43 See generally Separation of Costs of Regulated Telephone Service From Costs of Nonregulated Activities, CC Docket No. 86-111, Report and Order, 2 FCC Rcd 1298, 1317-18 (paras. 147-153); see also MCI Telecommunications Corp. v. FCC, 675 F.2d 408, 415-16 (D.C.Cir. 1982).

44 See, e.g., MCI Telecommunications Corp. v. FCC, 675 F.2d 408 (D.C. Cir. 1982) (discussing Docket 18128).

45 Further Notice, 3 FCC Rcd at 3337-38 (para. 259).

It is in part for this reason that I have proposed to alter the regulatory system, and impose an incentive structure. In contrast to conducting a pre-price cap rate case, the initiation of price caps using AT&T's existing rates would immediately introduce the type of efficiency incentives that result in the lowering of carrier costs. At the same time, AT&T would be provided with a limited amount of pricing flexibility that would enable it to begin to gravitate toward a set of more economically efficient prices. In short, a decision to employ existing rates would mean that significant benefits could immediately begin to accrue to consumers of AT&T services.

It is also important to consider the context in which existing rates would be used and how our price cap system would influence rates over the course of time. My proposed redefinition of AT&T's baskets would ensure that services subject to less competition are isolated from those subject to more competition. As a result, AT&T would be sharply constrained in its ability to employ its newly established pricing flexibility for anticompetitive purposes. The growing competition that exists for many of AT&T services would also serve to encourage competitive pricing, since large margins on services invite additional entry. The operation of the price cap formula itself would exert downward pressure on the aggregate prices in each basket through the operation of the productivity factor and, specifically, the Consumer Productivity Dividend. The initialization of the PCI at 100 for the base year would have the effect (all other things being equal) of reducing existing rates by 3 percent in real terms at the time of the first price cap filing. The CPD would result in a productivity adjustment that is higher than the historical productivity of the telephone industry, and would prevent AT&T from benefiting from past inefficiencies. In addition, parties would continue to have the opportunity in both the tariff review and complaint processes to challenge rates they consider unjust or unreasonable. This Commission would independently examine rate levels through the monitoring and performance review that are an integral part of the initial stages of price cap regulation. I believe that these factors, taken together, would assure that existing rates, filtered through our price cap formulas and procedural mechanisms, would produce price cap rates that are within the zone of reasonableness.

I agree with those parties that assert that pending investigations should be resolved as soon as possible. Under my direction, the Common Carrier Bureau is proceeding with those investigations expeditiously.[46] The existence of unresolved investigations, however, need not, and should not, delay the implementation of price caps. Should the Commission find, at the conclusion of one of these pending investigations, or any new investigation commenced on the Commission's own initiative or at the request of an interested party, that an existing rate is unlawful, I will recommend that we order refunds or make adjustments to the cap, or both.

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46 See AT&T Communications, CC Docket No. 85-326 and Transmittal Nos. 434 and 435, Memorandum Opinion and Order, FCC 85-584 (released November 7, 1985) (Megacom and Megacom 800); AT&T Revisions to Tariff F.C.C. No. 259, Wide Area Telecommunications Service (WATS), CC Docket No. 80-765, Memorandum Opinion and Order, 84 FCC 2d 158 (1980); AT&T Communications, Revisions to Tariff F.C.C. Nos. 1,9, and 10, CC Docket No. 85-203, 103 FCC 2d 157 (1985) (SDN).

Question 10: **In the so-called residential market basket for AT&T, there are some six different services. Under your price cap plan, which of these services will have the greatest rate decreases? increases? Will users of any of these services be worse off than under the current rate of return regulation scheme?**

Answer: The price cap plan I am proposing for AT&T ensures that residential/small business consumers will be better off than they would have been under continuing rate of return regulation. I have built into my proposal a number of ratepayer protections, several of which do not exist, and could not exist, under a rate of return regime. I will discuss each of these protections separately.

First, unlike the proposal adopted by the Commission in May 1988, I have proposed to segregate the group of AT&T services that residential and small business customers use into a separate basket, apart from the switched and private line services used by large telecommunications users. A separate basket protects residential customers by securing them against rate increases designed to permit AT&T to lower prices for other services. The re-definition of baskets, in my opinion, represents a substantial benefit to residential and small business ratepayers as a class. As I have indicated to you in my February 17, 1989 correspondence, segregating residential and small business services into a single basket is a necessary prerequisite to applying a series of other significant protections on rates consumers will pay.

The first of these additional protections concerns the flow through of exogenous cost changes and access cost changes. My proposal requires AT&T to flow through these cost changes at the basket level. Thus, residential and small business customers are guaranteed to receive their full share of future reductions in access costs and other exogenous cost decreases. This guarantee was not present under the basket configuration proposed in the Further Notice.

Next, under my proposal, rates paid by residential and small business users will be subject to downward pressure in the form of the Consumer Productivity Dividend in each and every year of price caps. Under rate of return regulation, carrier rates take into account changes in inflation, carrier productivity, and exogenous cost changes, such as decreases in access charges. My price cap proposal continues this practice, but instead of simply requiring rates to be adjusted downward by the historical amount of improvements in carrier productivity, my proposal creates an incentive for carriers to improve their productivity performance in comparison to historical levels. Most significantly, my proposal requires carriers to set aside an up-front share of their productivity performance in the form of a Consumer Productivity Dividend. The Consumer Productivity Dividend, therefore, creates downward pressure on rates that would not exist in the absence of price cap regulation.

Another aspect of my proposal that extends significant protection to residential and small business customers involves the decision to create

narrow service categories and to limit the upward movement in those service categories to 5 percent per year plus the change in the Price Cap Index. AT&T's basic domestic long distance service, MTS, is separated into four different categories: (1) daytime; (2) evening; (3) night/weekend; and (4) operator and credit card calling. My proposal also names international MTS and Reach Out America as separate categories in the residential and small business basket. As a result of the narrow categories and banding limitations, AT&T could not, for example, decide to raise its evening and night/weekend rates by any substantial amount, while lowering its daytime rates or international rates.

To underscore the Commission's commitment to the protection of residential ratepayers, I am proposing an additional constraint on AT&T's ability to price services in the residential basket. In addition to the constraint that aggregate prices in the basket cannot exceed the price cap limits, and the requirement that individual, narrow service categories not increase by more than 5 percent plus the change in the Price Cap Index, I propose to establish a separate constraint on the average residential rate. This constraint would place a two percent upward limitation on the annual change in the average residential rate relative to the annual change in the price cap index for the residential basket as a whole. This price constraint substantially limits AT&T's opportunity to manipulate its rates in the service categories I have identified, since residential ratepayers generate such a significant portion of the revenues for each of the six service categories.

In my February 17, 1989 correspondence with you, I discussed the results of an AT&T computer model and a computer model developed by the Commission's Common Carrier Bureau, both of which demonstrate that consumers will be better off under the price cap plan I am proposing than under rate of return. If this Commission adopts a plan with a separate residential and small business basket, AT&T anticipates that prices for all services in the residential and small business basket would be lower than rate of return prices by 2.0 to 4.5 percent after four years. AT&T projects that a price cap plan that includes a separate residential and small business basket would result in prices for residential consumers that are lower than rate of return prices by 0.8 to 3.3 percent. The Bureau's calculations estimate total savings over four years of approximately $900 million, representing $700 million savings for residence callers and $200 million savings for business callers.

Of course, beyond measuring the effects of the pricing constraints I am proposing, it is virtually impossible to predict precise movements in AT&T's rates for MTS, International MTS, and Reach Out America over the course of the next four years. Price changes for these services will be, and should be, dictated by future changes to costs and responses to competition. In my view, the salient feature of my proposal is that, were the Commission to elect to remain with rate of return, there would be far fewer constraints established by Commission rule on the pricing of these services than I am proposing under price caps.

Question 11: In its earlier price cap proposal, the Commission explained that placing switched services and private line services in separate baskets would "comport with [the] longstanding policy of ensur[ing] that message services do not subsidize private line services." Yet, you now propose to place business switched services and private line services in the same basket. How does this affect your policy against cross-subsidization? How much will rates for less competitive private line services increase under this new plan?

Answer: The combination of baskets and bands that I am now proposing for adoption is far better tailored to protecting against the dangers of cross-subsidization than is the system presented in the Further Notice or the rate of return system currently in use.

Under the current system of regulation, AT&T reports its earnings under two broad categories of service -- switched services and private line services. The Further Notice essentially proposed a continuation of this broad distinction in AT&T services by positing two baskets, one for switched services and one for private line services. The broad reporting categories that exist under rate of return were created by the Commission in 1981 to ensure that customers of switched services do not pay rates higher than they otherwise would be for the benefit of the large users that employ private line.

The current environment in which AT&T operates, however, is far different from the one that existed in 1981. The services I propose to include in the "business" basket are all targeted toward business customers that use large amounts of telecommunications services, generally a combination of switched and private line. Several of these services, such as the Pro America calling plans, SDN, and Megacom, are relatively recent entrants into AT&T's service offerings, and are specifically targetted to large users, as a private line services.

In response to Question 10, above, I have discussed how I propose to insulate residential and small business ratepayers from the dangers of cross subsidizing private line. With respect to the class of business customers that obtain switched services contained in the business basket, I am proposing that we require AT&T to establish seven separate categories of service that are each subject to limits on upward movement in price of 5 percent plus the annual change in the Price Cap Index. This pricing rule prevents AT&T from instituting a rapid run-up in prices for any service category in the "business" basket in order to subsidize any other service category. Moreover, the operation of the 5 percent limit, together with the downward pressure on rates created by the Price Cap Index I am proposing, provides users of these services with significant pricing protections not available under rate of return.

In addition, I do not believe that in view of current competition in the interexchange market, additional protections are needed. The AT&T services in the "business basket" are all subject to varying degrees of competitive pressure. Indeed, it is generally accepted that the business market is the most competitive of all markets served by interexchange carriers. While AT&T remains a dominant carrier, competition for these services remains a real constraint on AT&T's ability to maintain price levels for these services that could realistically be interpreted as a cross subsidy.

Question 12: Your latest proposal eliminates the prohibition on AT&T lowering prices for any service more than 5 percent annually. What services do you expect will benefit from this change?

Answer: The benefits of eliminating regulatory hurdles to price decreases accrue directly to consumers. Under the broad two-basket system proposed in the Further Notice, restrictions on downward movements in prices were necessary to prevent AT&T from exercising its pricing flexibility in such a manner as to disadvantage customers of less competitive services in order to disrupt emerging competition elsewhere. Even in the Further Notice, however, the Commission did not propose to prohibit decreases in prices beyond five percent. The Further Notice instead established that tariffs proposing percentage rate decreases larger than 5 percent would have to be accompanied by a special cost showing, and that decreases larger than 5 percent would not be credited in calculating compliance with the Price Cap Index.

By redesigning baskets and bands for AT&T, I tentatively believe we can avoid the need for regulatory intervention when AT&T seeks to decrease prices. My proposal, by dividing AT&T services into three groupings that tend to isolate one customer group from another, establishes a much more effective constraint on AT&T's ability to disadvantage one customer group to the benefit of another restraint that exists under rate of return. In addition, I am proposing various pricing constraints on upward mobility in prices that will prevent AT&T from engaging in drastic price increases in one service category so that it can remain whole while drastically reducing prices in another category within the same basket.

I also wish to clarify that price caps does not in any way put the Commission out of the business of reviewing rates for to ensure that they are just and reasonable, including that they are not predatory. Claims that a rate constitutes predation will continue to be reviewed as part of the tariff review process and the complaint process.

While I tentatively believe that unlawful predation is unlikely under the regulatory scheme I am proposing, I fully recognize the importance of this issue. It was, for instance, an issue raised during the congressional hearings last week. The matter remains under active consideration by the Commissioners.

Question 13: There is discussion in your price cap plan about passing through exogenous costs. What would be considered an exogenous cost? How large do you expect these costs to be, and how often would they occur?

Answer: In the Further Notice, the Commission proposed that price cap levels should vary, not only in response to changes in inflation and to expected improvements in productivity, but also in accordance with changes in certain exogenous costs. We defined "exogenous costs"[47] as costs which change due to changes in laws, regulations, or rules, or due to other administrative, legislative, or judicial changes beyond a carrier's control.[48] We tentatively found that we must adjust the cap for such costs in order to assure that the price cap formula does not lead to unreasonably high or unreasonably low rates.

We proposed to treat the following as exogenous cost changes: changes in access charges paid by AT&T; changes in costs due to tax law changes; changes in the rate of flow-back of excess deferred taxes; changes in expense levels due to the expiration of current amortization programs; changes due to amendments to Part 36 of this Commission's Rules, the Jurisdictional Separations Manual;[49] and changes due to amendments to Part 32 of this Commission's Rules, the Uniform System of Accounts (USOA).[50] We proposed not to extend exogenous cost treatment to changes in depreciation expense caused by changes in depreciation rates, nor to changes in international accounting rates.

For the most part, I propose to pass through under price caps those costs that the Commission selected for exogenous treatment in the Further Notice. Below, I discuss in detail these costs and some proposed modifications to the Commission's earlier proposal. However, with the exception of access costs, I cannot generally state in advance the size or frequency of expected exogenous changes. Most such changes, as I envision them, would be due to Commission-prescribed rules changes, which cannot be predicted in advance. On the other hand, access costs have historically comprised about half of AT&T's interstate cost of service, with major cost changes generally coinciding with the LECs' annual access tariff filings. Broadly speaking I would expect AT&T's access cost levels to continue to fall, though not to the same degree as has occurred during the last few

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47 These costs also are referred to as "exogenous factors" and "Z costs."

48 3 FCC Rcd at 3383 n.738.

49 47 C.F.R. {{ 36.001 et seq.

50 47 C.F.R. {{ 32.001 et seq.

years. Moreover, although I would propose that AT&T flow through access cost changes immediately upon their occurrence, the most significant changes would likely continue to occur on an annual basis.

Under the plan I am currently considering, switched and special access charges would be treated as exogenous costs. The rates which the LECs charge to AT&T for local exchange access are determined by tariffs filed by the LECs and reviewed by this Commission. Although actions taken by AT&T may have an impact on some of the costs which the LECs seek to recover through their access rates, the regulatory process through which this Commission decides whether to suspend, reject, or investigate an access tariff, or to allow it to take effect as filed, is beyond AT&T's control. Furthermore, because access charges are both unique to telecommunications companies and, for AT&T, very large, the impact on AT&T of changes in the price of access would not be adequately represented by the GNP-PI. For these reasons, changes in rate levels charged to AT&T for switched and special access are treated in my proposal as exogenous cost changes which trigger adjustments to AT&T's price caps.

The comments in response to the Further Notice convince me that our statement in the Further Notice to treat tax law changes as exogenous was at once overly-simplified and too complex. I agree with the parties who contend that treating tax law changes of all sorts as exogenous would likely result in significant "double-counting" of cost changes already reflected in the GNP-PI. At the same time, I believe that if there are tax law changes which affect AT&T uniquely or disproportionately, and which are sufficiently large that endogenous treatment would render price cap rates unreasonably high or low, then those changes should be treated as exogenous cost adjustments. Therefore, I will seek modification of the tentative conclusions in the Further Notice such that tax law changes will be presumed to be endogenous, but AT&T will be permitted to request exogenous treatment.[51]

After reviewing the record, I continue to support the Commission's tentative decision in the Further Notice to require an exogenous cost adjustment for changes in interstate costs which are caused by changes in the Separations Manual. As we stated in the Further Notice, Separations Manual changes are imposed by regulators and are ultimately outside the control of carriers. Furthermore, because Separations Manual changes do not represent changes in the carrier's input costs, but only changes in the allocation of those costs between the carrier's interstate and intrastate activities, such cost changes might not be reflected in the GNP-PI.

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51 Failure by AT&T to propose exogenous treatment of an unusual tax decrease would provide reason for an investigation of AT&T's annual filing.

I do not propose to treat as exogenous cost factors all changes in separations results. First, allowing flow through of all separations changes will not eliminate a carrier's incentive to shift costs to the jurisdiction where those costs are most readily recovered. It will merely give them a reason to seek out ways in which to shift costs to the interstate jurisdiction without causing reductions in intrastate revenues. Second, a carrier cannot achieve the kinds of traffic pattern shifts that would increase intrastate cost allocations without a state commission's knowledge. Third, increases in the allocation of costs to one jurisdiction may be due simply to increased demand in that jurisdiction. Such changes certainly should not receive exogenous cost treatment, since they would be accompanied by increases in revenue.

However, I believe there is a situation in which we might be required to make an exceptional exogenous cost adjustment because of a change in separations results that is not related to any change in the Separations Manual. It is possible that the allocation of cost to the interstate jurisdiction could increase at a time when interstate demand was static, due to a substantial drop in intrastate demand. In that circumstance, interstate costs could increase with no increase in interstate revenues. In such a circumstance, I believe the Commission should entertain a petition to treat some or all of such a cost increase as exogenous, especially if the decrease in intrastate usage was substantial and was brought on by factors beyond the carrier's control.

After reviewing the record, I continue to support the proposal in the Further Notice that changes in depreciation rates should not be afforded exogenous cost treatment. It is, of course, true that the Commission prescribes depreciation rates; indeed, we are required by the Communications Act to do so.[52] Pursuant to that statutory mandate, we have established methods and procedures which provide for full recovery of plant investment on a straight-line basis over the life of the plant.[53] Under such a system, the major determinant of the rate of depreciation is the service life of plant. It is the carrier, and not the Commission, that initiates proposal to deploy new plant and when to retire the old. It is, therefore, the carrier, and not this Commission, that primarily controls the rate at which plant investment is translated into depreciation expense.[54] The influence

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52 47 USC § 220(b).

53 See generally Property Depreciation, 83 FCC 2d 267 (1980), recon. denied 87 FCC 2d 916 (1981).

54 This is not to say that the Commission's staff never challenges a carrier's initial proposal for represcription of depreciation rates. Depreciation rates are usually prescribed for a future period of several years. Selection of a rate therefore involves forecasts of the future uses

which a carrier exercises over its depreciation expense thus differs both in degree and in kind from the influence which the carrier has over truly exogenous cost factors such as changes in the Separations Manual or the Uniform System of Accounts.

Even more important than the question of degree of control, however, is the question whether exogenous cost treatment of depreciation rate changes is consistent with the concept of incentive regulation. The idea behind price caps is to provide a carrier with the proper incentives toward efficiency and productivity. Some of the most basic decisions a carrier must make in its quest for improved productivity have to do with the deployment of plant. It must decide when to replace older, maintenance-intensive facilities with expensive but low-maintenance new plant; when to defer new investment; and how to achieve the ideal mix of capital and labor. If the Commission essentially guarantees recovery of one of the types of costs, i.e., depreciation expense, involved in these fundamental decisions, it would distort the process and risk destroying the incentives we wish to create. If, on the other hand, a carrier is required to live with the depreciation rates that result from its investment decisions, then the public can feel more assured that the carrier is making those long-term decisions in ways that will enhance productivity in the long run.

I also continue to support requiring a downward adjustment in the price cap index to reflect the expiration of current reserve imbalance amortizations. Contrary to the position taken by some commenters, I do not believe such treatment is inconsistent with my proposal regarding depreciation rates in general. The need to amortize depreciation reserve deficiencies was created, not by past decisions of this Commission regarding what plant lives should be, but by past methods of calculating depreciation expense. Formerly, the Commission used methods which caused reserve imbalances to develop when carriers accelerated the retirement of plant.[55] Our present methods assure that, on a going-forward basis, this problem will not recur. The amortizations currently in effect are part of the transition from the old to the new methods. They represent depreciation expenses that would have been included in rates over many past years if we had been using our current methods all along. In contrast to the decisive role of the carrier in determining its current depreciation expense levels, there is nothing the carrier can do now which will have any impact on the

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of billions of dollars worth of plant, along with analysis of the possible combined effects of thousands of management decisions that will be made. Even with the basic methodology established, and with agreement on the length of time over which a carrier must be allowed to recover an investment, the process is complex and there is room for disagreement on details.

55 See Property Depreciation, 87 FCC 2d 916, 918-919 (1981).

progress and expiration of these amortizations. No perverse incentives are created by requiring exogenous cost treatment of these amortizations. On the other hand, it would be unfair to ratepayers who are now bearing the cost of the amortization program if rates were not adjusted downward at the end of the program. I therefore reject the position taken by some commenters that depreciation expense and reserve imbalance amortizations must be treated identically in order to be treated consistently.

After reviewing the record, I support a confirmation of the Commission's tentative conclusion in the Further Notice that cost changes due to changes in the Uniform System of Accounts should be treated as exogenous cost factors. Although I also agree that there is no difference in principle between a cost change caused by a USOA change and a cost change caused by a GAAP change,[56] my proposal would not authorize carriers automatically to adjust price caps to reflect changes in GAAP. Current Commission procedures for implementing GAAP in the context of the USOA require carriers to notify us of their intention to apply a change in GAAP. Carriers may make the change only if we find it to be compatible with regulatory accounting needs.[57] Some changes in GAAP which are compatible with regulatory needs can be carried out within our existing rules, while others may require amendment of the USOA. Under my proposal, a carrier may not adjust its price caps to reflect a change in GAAP until the Commission has approved that change.

No party commented on the proposal in the Further Notice to deny exogenous cost treatment to changes in international accounting rates. I remain somewhat concerned about windfall profits, and about whether foreign administrations would be willing to consider reductions in accounting rates without the assurance that reduced accounting rates would be translated into reduced IMTS rates and thus into increased demand. Nevertheless, in the absence of record opposition on this issue, I will not initiate any change in the Commission's tentative decision to encourage AT&T to negotiate lower international accounting rates by treating changes in those rates as endogenous.

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56 Changes in generally accepted accounting principles are adopted by the Financial Accounting Standards Board (FASB). One could say that GAAP changes affect all entities in the economy and thus are already reflected in the GNP-PI. However, following this line of reasoning would require us by the same logic to prohibit exogenous cost changes for USOA changes that implement GAAP. Furthermore, it is not always clear that GAAP changes, implemented within a regulated system of accounts, have the same impact on carriers as the same changes implemented by industries which do not follow regulated accounting practices.

57 See ¶ 32.16 of this Commission's Rules, 47 C.F.R. ¶ 32.16.

Pactel has argued that adjustments required under Section 64.901 of our Rules due to failure of a carrier accurately to forecast relative regulated and nonregulated plant usage should be treated as exogenous cost adjustments to price caps. According to Pactel, exogenous cost treatment is necessary to assure that overallocations to regulated activities are corrected and the benefits passed on to consumers.[58] It is true that the Commission's Joint Cost Rules require carriers that use telecommunications network plant in the provision of nonregulated services to allocate common network plant on the basis of a three-year forecast of relative use, and to reallocate investment from regulated to nonregulated activities whenever a new three-year forecast so requires.[59] Under rate of return regulation, these cost allocations have a direct impact on regulated rates. Therefore, if AT&T's current rates reflected large amounts of regulated investment which were subsequently reallocated to nonregulated activities, I would agree with Pactel that a downward adjustment to AT&T's PCIs might be in order. At present, however, AT&T's nonregulated network services are minuscule. Current rates, therefore, do not include significant amounts of misallocated common investment, and will not need to be adjusted to account for any reallocations which AT&T might be required to make during the initial price cap period.[60]

Some commenters have argued that all cost changes required by this Commission should be accounted for in the price caps formula as exogenous factors. However, I believe it it would be premature to decide now that the effects of all of the Commission's future decisions about carrier practices ought to be flowed through to ratepayers as exogenous cost adjustments to price caps. Of course, the Commission most likely will have occasion to include in future decisions the determination whether the decision requires an adjustment to capped rates.

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58 Pactel Comments at 38, 39 n.55.

59 Carriers may not, however, reallocate costs from nonregulated to regulated activities except in unusual circumstances.

60 This does not mean that AT&T is relieved of the requirements of Section 64.901 of the Commission's Rules and the Joint Cost Order. I continue to believe, as stated in the Further Notice, that continuation of the Joint Cost Rules is necessary in order to maintain the integrity of the jurisdictional separations process. Furthermore, it will be necessary at the time of the performance review of the initial price cap period to determine accurately how much of the investment on AT&T's books is properly attributable to nonregulated activities.

Question 14: While you state that each of AT&T's three market baskets will get their fair share of further reductions in access charges, you do not guarantee that these reductions will be fairly passed on to each service within the baskets. Since the equitable sharing of access charge reductions has posed a problem in the past, how will you ensure that each service gets its fair share?

Answer: The composition of the baskets and the access charge rule I am proposing will ensure that access charge decreases are flowed through in an equitable manner under price cap regulation. Historically, when problems have arisen with AT&T flow through proposals, AT&T has been proposing to apply a significant amount of access charge decreases to services such as WATS or the optional calling plans, and a far lesser amount to MTS. Under my proposal AT&T must allocate access charge reductions among baskets on the basis of a per minute calculation. Since residential services are all in the same basket, and no business service is in that basket, this ensures that residential customers will get a fair share of access charge reductions and that AT&T would be unable to shift the benefits of access charge reductions from MTS to services targeted at business users. Nor do I believe that AT&T would be interested in misallocating access charge reductions between international and domestic MTS. It is not reasonable to expect that AT&T would use access charge reductions attributable to domestic MTS, a service for which there is competition, to reduce prices for IMTS, a service that is less competitive. Thus, a requirement that AT&T flow through access charge changes on a service-by-service basis appears to be unnecessary as a means of preventing misallocation. Moreover, the requirement that AT&T flow through access charge changes to each service ultimately may result in pricing inefficiencies.

The absence of a service-by-service flow through requirement should not be construed as giving AT&T complete discretion to flow through access in all cases. I propose to include in the price caps order a statement that the Commission will consider a petition for investigation of a below-cap rate filing, or to a complaint, if it appeared that cost changes had been applied to one service in a manner so manifestly unfair as to render rates for that service unreasonable.

Question 15: This past week you wrote me that you would seek to suspend and investigate any AT&T proposal to geographically deaverage rates. You, however, did not state that you would reject such a proposal as violating the 1934 Communications Act. Am I correct in understanding then that your proposal does not contain a prohibition on the deaveraging of rates and that the Commission may in fact permit such a tariff to take effect?

Answer: Your subsequent follow-up questions raise various additional questions concerning how best we can ensure the continuation of geographically averaged toll rates. I therefore plan to explain my thinking further on this matter in response to those questions.

Since its creation by Congress in 1934, the Commission has adhered to a policy of supporting geographic rate averaging. I personally am committed to this policy, and I assure you that all decisions that have been and will be made in this proceeding will be consistent with -- and will in no way contribute to undermining -- geographic rate averaging.

The information I have provided to you in recent weeks explains in detail the existing policies and rules that form the tangible foundation of the Commission's commitment to geographic rate averaging, and which would be continued under price caps. I also have informed you about my proposal to to establish a separate common line basket in the price cap plan for local exchange carriers, which would further ensure that incentive regulation will not lead to deaveraged rates.

Moreover, as an additional demonstration of my personal commitment to the continuation of geographically averaged rates, I pledged to you that the incentive regulation proposal I am urging my colleagues to adopt on March 16, 1989, will contain clear and unambiguous language stating that any AT&T tariff proposal to deaverage rates will be extended for the full notice period provided under Section 203 of the Communications Act, and will be suspended for the full period provided for under Section 204 of the Act and investigated. This would provide the Commission with eight months to consider such a tariff proposal.

You are correct in understanding that my current proposal does not contain an explicit prohibition on rate deaveraging. As I have stated in the past, I think the most prudent course of action at this time is to continue the policy approach followed by every Commission since 1934, which is to (1) recognize the strong economic incentives AT&T and other interexchange carriers have in maintaining averaged rates; (2) reaffirm through unambiguous statements the Commission's policy strongly favoring rate averaging; and (3) take affirmative actions to back up this policy by establishing and maintaining programs, such as pooling, that bolster interexchange carriers' existing economic incentives to maintain averaged rate schedules.

Moreover, it does not follow from my promise to ensure the suspension and investigation of any deaveraged tariff proposal that the Commission would permit such a tariff to take effect. In accordance with my promise, the Commission would have eight months to examine such a proposal, which is the maximum amount of time Congress has provided in the Communications Act for the study of any proposed tariff. That investigation could very well lead to rejection of any such proposal before it goes into effect.

Question 16: Nowhere in your recent proposal do you discuss the implications of the price cap plan on workers and the number of jobs in the telephone industry. How many workers have been laid off since divestiture? How many jobs have been created solely because of rate of return regulation? What do you expect to be the effect of the price cap plan on jobs in the telephone industry?

Answer: Reductions in AT&T's work force since divestiture have been widely discussed in the press. Although some of these reductions have occurred in the regulated side of AT&T's business, most have occurred on the unregulated side. The record in this proceeding contains no evidence that price cap regulation would have an adverse effect on jobs in the telephone industry. Indeed, the Communications Workers of America (CWA) has voiced strong support for the adoption of price caps caps. As indicated in the attached correspondence from CWA President Morton Bahr, that union has endorsed the immediate implementation of price caps for AT&T as a means of protecting jobs, arguing that AT&T needs additional flexibility to respond to the new competitive marketplace the Commission's policies have helped to create. The CWA also supports the expeditious implementation of price caps for local exchange companies.

Question 17: In a recent article about price caps, Professor Stelzer of Harvard says that it creates "perverse incentives" to reduce the quality of service. The Commission addresses this problem with findings that carriers would not reduce quality because customers want it, and even if they did, the Commission will monitor the situation. This reminds me very much of the airline situation. We will find out there is a problem only when people complain enough that the system is falling apart.

a. How can the Commission be so sanguine about its ability to ensure customer quality when it can do so little today about events with such severe repercussions as the Mother's Day fire in the Hinsdale, Illinois switching station and the recent breakdown in Charlotte, North Carolina?

b. Even if the Commission discovers a problem with service quality, I am not certain you can do much about it. First, you have already concluded that you have little idea whether any expenditures or investments are sound. How then can you tell what is needed to fix a service quality problem? Second, even if you find a problem, because of the lead time needed for improvements, won't it take many years to correct the situation?

Answer: My response to this question starts from the proposition that in general AT&T and the LECs provide a satisfactory level of service quality at the present time under rate of return. In fact, no party to the price cap proceeding argues that the existing service quality provided on the public switched network is substandard. Most of the comments that request additional service quality protections begin their analysis from the position that we ought not to tolerate any decline in service quality from its present level. Thus, the principal question that presents itself for resolution is whether price cap regulation will cause the network to deteriorate, as AT&T or the LECs pursue short term profits.[61]

There are a number of constraints on AT&T's ability to degrade its quality of service under a price cap regime. Since price cap regulation compels AT&T to act like any other for-profit firm, a decision by AT&T to

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61 The 1988 fire in the Hinsdale, Illinois switching facility and the 1987 accident in which an AT&T cable was cut in Charlotte, North Carolina were not examples of service disruptions that required Commission intervention to correct. In fact, both Illinois Bell and AT&T went to great lengths to restore service to their facilities quickly. I believe these two incidents provide strong evidence that it is in the carrier's best interest to correct any failures in its network expeditiously. See, e.g., "The Nightmare on Lincoln St.," Telephone Engineer and Management, July 15, 1988 at 82.

degrade its service quality would have to be based on a decision that such a strategy will not cause profits to decrease, a difficult judgment at best. In addition, AT&T would have to implement a deferred maintenance or underinvestment strategy in the face of monitoring at both the federal and state level, thereby inviting regulatory intervention if quality of service measures show a decline. Furthermore, since many parameters of service quality are contained in AT&T's tariffs, changes in these parameters would have to be made in the context of a public, non-streamlined tariff proceeding. Finally, the competition that exists for AT&T's services provides substantial assurance that AT&T would not degrade its quality of service, since its customers may seek out alternative suppliers of long distance service. While I believe that these factors will prevent deterioration of AT&T's service quality, I also wish to emphasize that a decline in AT&T's service quality, manifested in an increased number of complaints about its service, or changes to technical standards contained in its tariffs, would certainly renew my interest in adopting additional service quality protections.

First, as the Commission stated in the Further Notice, it is not immediately apparent that AT&T would view underinvestment or deferred maintenance as profit-maximizing behavior, either in the short term or the long term. Deferred maintenance would obviously lead to fewer available circuits, which means fewer messages are completed and less revenue is generated. Before embarking on a policy of deferred maintenance, AT&T would have to decide that it would save more in maintenance expenses than it would lose in revenues, a calculation fraught with complexities.[62]

Second, the Commission's existing monitoring efforts also provide a check against service quality degradation. As we discussed in the Further Notice, the Commission currently receive service quality monitoring reports from AT&T on a semi-annual basis. In the past, those reports included statistics on switch performance, analog transmission between AT&T's switches, and a report on circuit availability from the terminating toll office to the called party's premises. On October 20, 1988, AT&T announced an amendment to its quality of service report that substantially expands its scope to include measurement of digital transmissions on AT&T's network. Thus, while the previous statistics measured individual pieces of AT&T's public switched network, AT&T's new report provides data that will reflect the customer's experience in using AT&T's network, i.e., from the originating toll office through the completion of the call.

AT&T's new report, titled "Outgoing Trunk Service Evaluation," measures both circuit availability and equipment performance, and like the reports it supersedes, is capable of differentiating between busy/do not

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62 See Further Notice, 3 FCC Rcd at 3265 (para. 134).

answer signals and equipment-related blockages and failures. Most significantly, however, the new report is capable of measuring the quality of calls made over digital facilities, a rapidly-growing portion of AT&T's network. AT&T also will retain its "Network Trunk Transmission Measurement Plan" to track the experience of calls transmitted over analog facilities.

In addition to these monitoring reports, which provide either a measure of AT&T's ability to meet service quality objectives or a measure of change in service quality performance, this Commission also collects data pursuant to annual facilities authorization requests. Information collected under this Section 214 process also can serve as an indicator of whether AT&T is providing adequate transmission capacity on its network. The circuit utilization data collected in the Section 214 proceedings, together with a report of AT&T's construction plans and its demand forecasts, provides another indication that AT&T is committed to maintaining a high quality network. Data on gross plant additions that we have collected through our Form M requirements, and will continue to collect through our ARMIS reports, can also serve this purpose.

The data we collect are meaningful and useful in detecting any general decline in the quality of service AT&T provides. To pinpoint local or sporadic service quality problems, the Commission relies on subscriber complaints. The complaint process both provides a forum for the resolution of particular service quality complaints and serves the broader and more important function of acting as a warning system of service quality deterioration. I believe that many manifestations of service quality decline are easily detectable by ratepayers in the form of blocked calls, poor transmission quality, or slow installation and repair service. Indeed, the private line provisioning problems AT&T experienced under rate of return after divestiture triggered many complaints to this Commission, with the result that we began obtaining provisioning reports from AT&T. When the provisioning problem was rectified, we discontinued the reporting obligation. Furthermore, as suggested by some commenters, state quality of service monitoring can to some extent supplement our own monitoring efforts, and is especially helpful in drawing attention to more localized problems.

In addition, many performance standards are provided in AT&T's tariffs.[63] I am not proposing that we streamline our review of proposed revisions to tariff terms and conditions, including terms and conditions relating to quality standards. Therefore, any attempts to revise tariffs

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63 See, e.g., ATT Tariff F.C.C. No. 9, Section 8.2.1.D (establishing parameters for voice grade private line, including: loss variation, attenuation distortion, C-message noise limit, C-notched noise limit; signal to C-Notched Noise Ratio, Intermodulation, Distortion, Envelope Delay Distortion, Impulse Noise, Frequency Shift, Phase Jitter).

terms or conditions, including service quality standards, remain subject to 45 days' notice and the possibility of rejection or suspension and investigation to determine their lawfulness. In these cases, therefore, any AT&T attempts to change service quality terms or conditions would have to be made in the context of a public proceeding in which AT&T would have to justify its proposals.

Finally, those commenters that view AT&T as not subject to much competition, warn that service quality standards, or increased monitoring, are essential if we are to prevent AT&T from underinvesting or deferring maintenance on its network under price cap regulation. Those commenters that view AT&T as subject to significant competition, argue that marketplace pressures, coupled with existing service quality monitoring of AT&T, are sufficient to keep service quality high. In my previous correspondence with you, I indicated that I believe AT&T is in fact subject to a degree of competition, although it remains the dominant carrier of interstate toll messages. In the case of service quality, however, it is not the number of competitors that is relevant, but whether there is any facilities-based competition to AT&T's network. Only if rival networks are available to customers can competition be relied upon to help maintain service quality. There are currently four fiber optic networks providing facilities-based competition to AT&T. The fiber optic systems owned by MCI and US Sprint each appear to have sufficient capacity to accommodate all domestic interLATA traffic for the foreseeable future. Given the alternatives to AT&T's network, I believe that competitive forces are more than likely to provide the impetus for AT&T to maintain its existing service quality levels, at least along those routes where facilities-based competition exists.

My determination on this issue is further buttressed by my view of the importance of network quality in the public statements and marketing campaigns of the interexchange carriers. While I agree with the Colorado OCC that an emphasis on quality in advertisements is not necessarily indicative of actual service quality, the prominence that service quality receives in carrier efforts to sign new customers will lead consumers and users to expect high quality service, and to seek out an alternative service competition to operate effectively to deter service quality deterioration, customers must be able to change to a different facilities-based carrier.

While a number of commenters argue that we should become more active in the service quality area with the advent of price cap regulation, I am not convinced that additional federal requirements are necessary at this time for AT&T. Facilities-based competition for AT&T's services will force AT&T to maintain the quality of its network. For those areas not subject to facilities-based competition, I believe that our existing monitoring program, as well as our complaint process, provide us with enough information to detect a drop-off in service quality. In making this decision, however, I am mindful that we possess an array of regulatory options that could be brought to bear should AT&T service quality degrade.

The adoption of our own performance standards, increased monitoring, or even the adoption of contractual liability for installation and service failures are examples of the types of relief I would consider in the future should AT&T's service quality decline.[64] Furthermore, I propose to make service quality one of the criteria by which we evaluate the success of the price cap regime beginning at the end of its first three years. Our continued vigiliance during the initial period, together with the opportunity for more extensive exploration of this subject as part of the performance review, should also deter AT&T from inviting regulatory intervention into its own network performance objectives.

With respect to the effects of price caps on LEC service quality, I find strong evidence that price caps will not adversely affect the quality of the LECs' interstate services. First, the LECs' primary customers for interstate access are sophisticated interexchange carriers such as AT&T, MCI, and Sprint. Such customers possess the technical expertise and the incentive to use that expertise to uncover any decline in service quality. Upon detecting such decline, these users also are likely to call upon their considerable legal resources to pursue complaints at this Commission and state commissions. Such interexchange carriers function effectively as large, sophisticated, expert surrogates for small individual users.

Second, because revenue for interstate access is largely usage sensitive, LECs have significant incentives to prevent declines in service quality that might lead to call blockage. Admittedly these incentives do not apply to all dimensions of service quality. Nevertheless, because of the interdependent nature of the network, increasing capacity in order to prevent blocked calls will also have positive effects on other elements of service quality.

Third, the facilities used to provide interstate access service are the same facilities that the LECs use to provide intrastate services. Since most states have specific service quality standards and monitoring programs complementing our programs, it is unlikely that a LEC could degrade service

I therefore tentatively conclude that there are sufficient forces pressing the LECs toward maintenance of high quality service to deter any LEC from cutting costs in ways which degrade service quality. Based on this conclusion, I further tentatively conclude that there is no need for this Commission to take active measures to assure LEC service quality during the

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64 I therefore disagree with arguments that network quality would be impossible to recreate if allowed to deteriorate. Indeed, as evidenced by Oftel's treatment of British Telecom, it is possible to assert regulatory controls that improve service quality. See B. Carsberg, "The Control of British Telecom's Prices," Oftel Statement, released July 7, 1988, at 32.

initial price cap period. Accordingly, I do not propose to adopt specific service quality standards.

Nevertheless, I am sensitive to the concerns expressed by state commissions and users about the possible impact of price caps on LEC service quality. Both to allay those concerns, and to provide the Commission with data to assist our evaluation of our price caps program, I propose to monitor the quality of service provided by LECs subject to price cap regulation.

The comments suggest several possible monitoring mechanisms. We could retain the service quality reports currently required of the BOCs, and extend that reporting requirement to the other price cap LECs. We could adopt a new reporting requirement along the lines suggested by BellSouth and Rochester. Or, as an alternative to a reporting requirement of our own, we could require carriers to submit to us copies of any service quality reports they submit to state commissions. I tentatively conclude that, of these three options, the BellSouth/Rochester proposal is preferable because it is the one most likely to produce data which can be used for benchmark comparisons as well as for tracking the progress of each individual LEC.[65]

Question 18: The price cap plan uses current rates as the starting point for the price cap. Yet, many of these tariffs are under investigation. Other tariffs while going into effect can still be challenged and be found unlawful. The underlying cost support for certain tariffs may have changed since the tariffs first went into effect. Just because the sum of all the tariffs yields a reasonable rate of return does not necessarily mean that any particular rate is reasonable. Why then rely on them?

Answer: For the reaons stated in my response to Question 9, I believe that relying on existing rates is both a reasonable and appropriate starting point for the initiation of price cap regulation.

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65 Some of the data currently collected in the BOC service quality reports is in a form which does not facilitate inter-company comparisons. For example, transmission quality is reported as the percentage of a company's offices which meet the company's own standards for transmission quality. Reliance on service quality reports required by various states would produce disparate data, or, for carriers operating only in states which lack service quality reporting systems, no data at all.

Question 19: Tariffs do not only contain rates but also various terms and conditions. In addition, telephone companies engage in "off-tariff" marketing practices, such as paying commissions and discounting equipment. If the price cap plan is adopted, would it lessen the opportunity for outside parties to question these practices and for the Commission to review them?

Answer: No. Under the proposal I am presenting to my fellow Commissioners, restructuring of tariff terms and conditions must be proposed on 45 days' notice, just as it is today under rate of return. Interested parties would have the same opportunity to review and object to new terms and conditions under price caps as they do today under rate of return regulation.

As for the "Off-tariff" marketing practices noted in your question, such practices are not common carrier services and, therefore, are not generally subject to the Commission's Title II regulatory authority. This does not mean that the Commission is indifferent to such practices. Recently, for example, the Common Carrier Bureau addressed a complaint filed under Section 208 of the Act alleging that AT&T was tying certain marketing practices and regulated services together in an anticompetitive manner. The Bureau found that AT&T's practice of paying private payphone commissions for collect calls, calls billed to third numbers, and credit card calls only to those private payphone operators that presubscribed their payphones to AT&T's long distance service was unlawful.[66] Evidence of unlawful practices will continue to be scrutinized by the Bureau under price caps.

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66 AT&T's Private Payphone Commission Plan, 3 FCC Rcd 5834 (1988), app. for review pending.

Question 20: The Commission's price cap plan is only applicable to approximately 25% of the costs of the local telephone companies. Since 75% of the costs may be regulated under a different method, why should the price cap plan drive the local telephone companies to seek greater efficiencies? In addition, will this jurisdictional split give the telephone companies a greater incentive to shift costs to gain the greatest return? If so, why does the Commission believe that its monitoring plan will prove sucessful since the data must be provided from the telephone companies?

Answer: Pursuant to the dual, federal/state jurisdictional structure established by Congress under the Communications Act, approximately 25 percent of total local telephone company costs would be subject to a uniform FCC price cap regulatory system, if adopted, while the remaining 75 percent would remain subject to the various regulatory policies administered by the fifty individual states. Local telephone companies are private, profit-oriented entities, and have every incentive to maximize profits where ever possible, certainly with regard to 25 percent of their costs. Moreover, the trend in regulatory reform at the state level is toward incentive regulation principles like those embodied in my proposal. As this trend continues, an increasing portion of the 75 percent of local telephone company costs subject to state regulation will be affected by the efficiency-enhancing incentives of price cap regulation.

The incentive to shift costs is inherent in the bifurcated structure established by Congress unless Federal and state regulation are identical, and this has never been the case. Today, even in situations in which a state employs rate of return approaches similar to the FCC's, the incentive to shift cost between jurisdictions exists because most state rate of return prescriptions differ from this Commission's.

In order to guard against cost shifting, this Commission, working with the states, has developed rules to govern jurisdictional cost allocations (i.e., jurisdictional separations) and to monitor the allocational process. The combination of the separations rules, and federal and state monitoring would continue under price caps to provide effective means of identifying and enabling the prevention of misallocation of costs to either the state or interstate jurisdiction.

This Commission's ability to monitor the jurisdictional cost allocation process has increased significantly during the past two years because of the development and implementation of a computerized reporting system that we call ARMIS. ARMIS regulations requires carriers to report data by state and interstate jurisdiction, and will enable this Commission to track cost allocations over time. These data will be made available to the states and other interested parties. Both state regulators and this Commission can then judge whether further investigation or auditing is required. Indeed, ARMIS data should be of substantial benefit to the states.

The ARMIS system is already in place for the LECs, so baseline data concerning LEC operations will be available for making pre- and post-price cap comparisons. The process of establishing parallel reporting requirements for AT&T is nearly complete. The Commission chose to implement ARMIS on a staggered basis because the vast majority of telephone company costs subject to the separations process are LEC costs. Moreover, approximately fifty percent of AT&T's interstate costs consist of payments made to LECs for the purchase of access services, and these costs cannot be shifted between jurisdictions. The existence of competition for AT&T service at both the Federal and state levels further reduces AT&T's ability to shift costs.

As noted above, the cost shifting issue is being affected materially as a result of the trend in regulatory reform at the state level. To the extent that a carrier is subject to incentive regulation in both the state and the interstate jurisdiction, any incentive to shift costs between jurisdictions would be minimized. Evidence in the record indicates that many states have moved or are moving from rate of return regulation to incentive regulation. At least 17 states already have moved away from rate of return regulation of AT&T's intrastate offerings; Colorado and California recently announced their intentions to move this way as well. With regard to the LECs, the State of New York has introduced a profit-sharing plan and rate moratorium; states such as Ohio, Maryland, New Jersey, Virginia, and West Virginia also have introduced some flexibility or streamlining into LEC regulatory systems. Other states are considering incentive-based reforms, including Illinois, Michigan, Iowa, Indiana, the District of Columbia, Massachusetts, Vermont, Florida, California, Nevada, Oregon, and Washington. Thus, even if adoption of incentive regulation at the federal level were a legitimate basis for concern about increasing incentives to shift costs to the states, the trend in regulatory reform at the state level is diminishing those incentives.

Finally, it is important to note that no changes in jurisdictional separations rules or processes are proposed in the price cap proceeding. This Commission will, however, continue to monitor compliance with such rules, enforce them, and work with state regulators through separate Joint Board proceedings to modify and update the separations rules in an effort to ensure that a rational and effective cost allocation system exists that reflects current technology.

**FCC Chairman Dennis R. Patrick's Responses to
Senator Larry Pressler's Questions Following Up
On U.S. Senate Communications Subcommittee Hearing
On FCC Price Cap Proposal, March 1, 1989**

Question 1: You have committed yourself to maintaining geographic rate averaging. What actual mechanisms will be in the rules to ensure geographic rate averaging?

Answer: I personally am committed to the policy of geographic rate averaging, and I assure you that all decisions that have been and will be made in this proceeding will be consistent with -- and will in no way undermine -- geographic rate averaging. I think the most prudent and effective means of addressing the issue at this time is to continue the policy approach followed by every Commission since 1934, which is to: (1) recognize the strong economic incentives AT&T and other interexchange carriers have in maintaining averaged rates; (2) reaffirm through unambiguous statements the Commission's policy in favor of rate averaging; and (3) effectuate this policy by maintaining programs in our rules that reinforce interexchange carriers' existing economic incentives to maintain averaged rate schedules. As I explain in more detail below, in the price cap proceeding we have proposed to reinforce the foundation of geographically averaged rates both by retaining existing rules and programs, including the important Unity 1-A safeguards adopted by the Commission two years ago, and by promulgating price cap rules that would place common line rates into a separate basket. I want to take this opportunity to review briefly each of the three components of this approach.

First, the incentives long distance carriers have to maintain geographically averaged rate schedules are easily recognized. AT&T began averaging its toll rates geographically long before the Commission was established by Congress in 1934. The OCCs choose to rate average geographically even though they are not compelled by regulation to do so. This is unsurprising, considering the very large administrative costs that would result from an attempt to calculate, market, and bill a system of deaveraged rates.

Second, the Commission repeatedly has voiced its support for the continuation of geographic rate averaging. Most recently, the incentive regulation plan adopted by the Commission on March 16, 1989, reaffirms support for this policy. The order adopted by the Commission contains clear and unambiguous language stating that any AT&T tariff proposal to deaverage rates will be extended for the full notice period provided under Section 203 of the Communications Act, and will be suspended for the full period provided for under Section 204 of the Act and investigated. This would provide the Commission with eight months to consider such a tariff proposal. Given the importance of the Commission's policy favoring averaging, I would anticipate that the Commission would complete its investigation during the eight-month period. AT&T would have the burden of proof of justifying its deaveraging proposal, and I would expect this to be a very difficult task under our policy.

Third, the records of many Commission proceedings held over the years -- particularly the many and various aspects of the Dockets 70-78 and 80-286 access charge proceedings -- attest to the fact that the continuation of averaged rates does not depend primarily on whether the Commission adopts an edict stating that rates shall be averaged. Rather, the most effective steps the Commission can take to ensure the continuation of averaged rates are the development and implementation of the kinds of policies and programs that are tailored to complement and reinforce long distance carriers' incentives to maintain averaged rate schedules. Put another way, no rule simply commanding averaged rates likely could be sustained in the long run unless the Commission provides the means to maintain averaging. We have consistently adopted policies and promulgated rules that address the possible causes of geographically averaged rates, and we will continue to do so.

Many of the most important of these policies involve rules and procedures governing the manner in which local exchange carriers (LECs) recover the costs they incur in providing access for interstate services, particularly their common line costs. LEC interstate access costs vary from carrier to carrier, often widely. The Commission currently administers a series of policies and rules designed to ensure that these cost differences do not put undue pressure on long distance carriers to geographically deaverage MTS toll rates. The bulk of these policies and rules take the form of technical provisions within Part 69 of the Commission's rules, and include the so-called Unity 1-A safeguards adopted by the Commission two years ago.

We intend to retain all of these policies and rules relating to rate averaging under our revised LEC price cap proposal. Let me describe these policies and rules in some detail.

Under those policies and rules, LECs currently have the option of proposing rates for their interstate switched access services that are averaged at a level as low as the study area(s) they use for purposes of jurisdictional separations.[1] These policies and rules are the result of a series of Commission decisions made during the past six years in notice and comment rulemaking proceedings.[2]

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1 A study area generally is a local telephone company's service area. For the Bell Operating Companies, which comprise 80% of the inudstry, study areas span entire states. As the glossary to Part 36 of the Commission's rules specifies, the boundaries of study areas were frozen as of November 15, 1984. Thus, no carrier is able to manipulate those boundaries to disadvantage rural areas by separating them from nearby urban areas.

2 See e.g., MTS and WATS Market Structure, Third Report and Order, CC Docket No. 78-72, 93 FCC 2d 241 (1983)(Access Charge Order); MTS and WATS Market Structure, Recommended Decision and Order, CC Docket Nos. 78-72 and 80-286, FCC 87J-1, 2 FCC Rcd. 2324 (Joint Board Order); MTS and WATS Market Structure, Report and Order, CC Docket Nos. 78-72 and 80-286, 2 FCC Rcd 2953 (1987)(Pooling Modifications Order).

In 1983, for example, the Commission adopted a plan, commonly known as the access charge plan, that establishes the rate structure all LECs must follow in recovering their costs of providing switched interstate basic services. That plan established two main categories of LEC charges for the recovery of costs that affect rate averaging: (1) traffic sensitive charges; and (2) the carrier common line charge. In conjunction with adopting the plan, the Commission determined that the public interest did not require LECs to participate in cost pooling and joint tariffing arrangements with regard to their traffic sensitive charges, but that cost pooling and joint tariffing arrangement would be required for LEC common line cost recovery. The Commission made these determinations in large measure because it concluded that a cost pooling and joint tariffing arrangement for common line costs was necessary at that time to prevent undue pressures on long-distance carriers to deaverage their rates because of the then-existing disparities among LECs with regard to common line costs.[3]

In line with the Commission's legal obligation to review its policies and rules from time to time to ensure they continue to further the goals they originally were designed to achieve, the Commission in 1986 asked a Federal-State Joint Board to review certain portions of the access charge plan, including the determination to require a cost pooling and joint tariffing arrangement for carrier common line cost recovery. This Joint Board, which was comprised of four state commissioners and three FCC commissioners, conducted a proceeding in accordance with notice and comment procedures, considered the issues referred to it, and issued a series of recommendations to this Commission. These included a recommendation that this Commission modify the pooling requirement in a way that preserves long distance carrier's incentives to maintain geographically averaged rates yet permits individual LECs greater flexibility to tariff rates based on their own cost of service.[4] With minor exceptions, this Commission subsequently adopted the Joint Board's recommendations.[5]

In making their determinations about pooling and LEC averaging, the Commission and the Joint Board listened carefully to the concerns expressed by proponents of geographically averaged rates, and went to great lengths to craft policies that would preserve geographic rate averaging by maintaining significant limits on the disparity in access rates that long distance carriers have to pay different local exchange carriers.[6]

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3 See Access Charge Order, 97 FCC 2d at 326-330.

4 See Joint Board Order.

5 See Pooling Modification Order.

6 These arrangements also provide several other benefits to small telephone companies and their subscribers. They eliminate direct tariff

The incentive regulation order adopted by the Commission on March 16th proposes no changes to existing rules and procedures governing the pooling process, including the rules governing transitional and long-term support payments. Also, no changes are proposed to rules and procedures commonly associated with the pooling process or necessary to assure that the pools can continue to be administered effectively, such as the Uniform System of Accounts (USOA) and current jurisdictional separations rules. In addition, we are proposing no changes in the rules governing the administration of the Commission's High Cost Fund support program, including the rule amendments adopted by the Commission that target more support for small telephone companies.

Moreover, the incentive regulation proposal for LECs adopted by the Commission on March 16th is crafted to ensure that implementation of price caps would not disturb the policies and rules developed over the years to preserve rate averaging. Specifically, as I explain in more detail in answer to Question 2, we have sought to help ensure the continuation of geographically averaged rates under price cap regulation by modifying the proposal set forth in the Further Notice include a separate "basket" for common line costs.

Question 2: Could you explain how your separate common line basket for local exchange carriers will provide insurance against deaveraged rates?

Answer: In the May 1988 Further Notice, the Commission suggested that LEC interstate access services be grouped into two price cap "baskets" -- one for switched access services, and one for special access services. Under that proposal, common line charges used to recover interstate nontraffic sensitive costs was to be included in a price cap basket of services which also included traffic sensitive charges. Within this basket, the Commission proposed to provide LECs a limited amount of pricing flexibility (i.e., rates for one service could be raised a certain amount as long as the rate(s) for equally weighted service(s) were reduced an equal amount).

Nevertheless, this proposal gave raise to a concern on the part of some commenters that this limited pricing flexibility might be used by LECs under price cap regulation in a manner that would result in widely divergent common line rates and, therefore, would place undue pressure on AT&T to deaverage its rates geographically.

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filing burdens on small companies, reduce their operating risks substantially, and greatly increase their ability to achieve a steady interstate rate of return on investment. All of these benefits ultimately redound to subscribers because such benefits help to ensure that telephone service is available at reasonable rates. Thus, in addition to supporting rate averaging, such arrangements promote the important goal of universal service in many different ways.

The Commission addressed this concern on March 16 by adopting a new proposal for LEC price cap regulation in which common line rates are segregated into a single basket. Under this proposal, LECs would have no flexibility above and beyond the cap on common line charges to raise common line rates. Put more simply, the plan proposed by the Commission on March 16 eliminates the kind of LEC pricing flexibility that commenters argued might force AT&T to geographically deaverage its rates.

Question 3: Do you have any plans to make price caps mandatory for small telephone companies, or do you expect that to remain an option after your three-year review?

Answer: There is no provision in, nor any aspect of, the proposal adopted by the Commission on March 16th that would result in the mandatory application of price cap regulation to small companies. That proposal, if adopted, would make price cap regulation mandatory for depooled, Tier 1 LECs, none of which is considered a small company. Price cap regulation would be optional for all other LECs, including small telephone companies.

Question 4: When do you expect to implement price caps for the Regional Bell Operating Companies?

Answer: July 1, 1990, is the date tentatively selected by the Commission for implementation of LEC price cap regulation. If we could satisfactorily resolve all the remaining LEC issues soon enough, I believe that it might be possible to implement incentive regulation in conjunction with the Commission's review of LEC tariff filings scheduled to take effect on January 1, 1990.

Question 5: Some have maintained that your productivity factor of 3 percent is not great enough. If it becomes apparent that actual costs are decreasing faster than 3 percent, will you revise this factor?

Answer: The incentive regulation plans the Commission has adopted for AT&T and proposed for the LECs cannot, and do not, allow carriers to earn excessive profits in light of their costs. These plans provide for continued monitoring of carrier cost and profit data, and, after the first three years, for a comprehensive review of their performance, which will include evaluation of the relationship between rates and costs. The Commission would stand ready to make any necessary adjustments to the plan indicated by that monitoring or performance review. During the interim, the use of rate-of-return-generated existing rates to establish initial price caps, and the subsequent price cap adjustments made pursuant to the plans, should keep carrier profit levels in check. Moreover, as part of its tentative plan for implementing price cap regulation for the LECs, the Commission is proposing to build a "backstop" into the plan, either an automatic stabilizer or an earlier comprehensive performance review, which would operate to ensure that LEC rates remained just and reasonable.

The price cap plans also retain tariff investigation and complaint proceedings under Sections 204 and 208 of the Communications Act, 47 U.S.C. §§ 204 and 208, which will continue to involve scrutiny of the nexus between carrier rates and their costs and profits.

It is important to emphasize that the 3 percent productivity factor built into the price cap plans the Commission has adopted for AT&T and proposed for the LECs was selected after careful study of data relating to the long-term productivity achievements of the telecommunications industry. Although these data indicate that long-term productivity in the industry was below 2.5 percent annually for the industry, relative to the economy as a whole, the Commission selected a 3 percent productivity factor for use in price cap regulation in order to ensure that consumers are better off under this form of regulation than they likely would be if existing regulation were continued.

Moreover, although it is unlikely that a carrier would be able to boost its productivity under price caps on anything other than an incremental basis, in the long-run, such productivity gains should be welcomed, not a cause for concern. If a carrier actually does improve its productivity -- revealing to the public that it can be more productive than it historically has been under rate of return regulation --the benefit of this improvement will flow to ratepayers in the long run because this information will be used during the comprehensive review of caps to benefit ratepayers, such as by adjusting the carrier's productivity factor upward, just as the British government did with its dominant carrier, British Telecom, after a few years of experience with price cap regulation in the United Kingdom. Equally important in my view, incentive regulation is structured to ensure that consumers receive lower rates under price caps than history indicates they would receive under rate of return regulation, whether a carrier improves its productivity or not.

ADDITIONAL ARTICLES, LETTERS, AND STATEMENTS

Statement of the United States Telephone Association

The United States Telephone Association respectfully submits this statement to the Committee on Commerce, Science, and Transportation of the United States Senate. USTA is the principal trade association of the local telephone industry. Its membership of approximately 1100 local telephone companies provides 99 percent of the local telephone company-provided access lines in the United States. USTA's member companies are the providers of local telephone, access and other telecommunications services to residential and business customers in assigned areas throughout the nation.

This statement addresses the actions of the Federal Communications Commission in a proceeding commenced two years ago to investigate alternative forms of regulation. The FCC appears to have completed its assessment of the exhaustive record in that proceeding, and has signaled that it is ready to act on some form of mechanism for incentive regulation for the carriers over which it has jurisdiction.

The pending proceeding is of critical importance to the local telephone industry. It can result in an effective alternative form of regulation designed to meet today's changing regulatory demands. It can allow local telephone companies to respond to changes in the telecommunications marketplace more efficiently than under current "rate of return" regulation, and to benefit customers as a result. Because a balanced form of alternative regulation can reduce prices for consumers and provide incentives for carriers to innovative, any delay will postpone public benefits. The FCC has estimated benefits with its price cap proposal of $900 million for AT&T. Participation by local companies can increase that figure substantially. It is important that incentive regulation include the local companies and AT&T.

USTA has supported the application of price cap regulation, on a voluntary basis, to the interstate access services provided by local telephone companies. The FCC's actions would apply *only* to interstate telecommunications, and not to intrastate services. Local telephone companies play a major role in the delivery of interstate long-distance services. The access connections they supply generate about 50% of the costs of interstate toll calling.

Incentive regulation can lessen the cost of regulation. It can shield customers from abrupt rate increases, yet guarantee that rates will remain below an inflation index, and therefore constantly decline in real dollar terms, even more so than under existing procedures. The carrier becomes committed to a consumer dividend, which provides the impetus to innovate. This form of regulation can be most effective in a market with natural monopoly attributes. Price cap regulation encourages a competitive market-based response to costs and to ever-advancing technology.

As a regulatory alternative that better replicates market forces, it can allow a carrier the necessary leeway to manage its own business better within a well-defined framework. While a carrier will be able to make business decisions that involve some risk, the burdens of that risk are borne by the carrier, just as the potential rewards lead it to innovate.

No one in our industry views any of the alternatives considered by the FCC to be deregulation. Since incentive regulation is not deregulation, it would not diminish the FCC's authority or its responsibility under the Communications Act to ensure reasonable rates. It also would not affect a state commission's jurisdictional authority over intrastate services. It would not alter current procedures to separate interstate and intrastate costs, nor would it increase opportunities to cross-subsidize. Experience with incentive regulation in the states has shown that improper cross-jurisdictional subsidies have not resulted from such a change.

A change in the form of regulation for interstate rates can offer great benefits to the consumer. The current ratemaking scheme allows carriers to charge for their operating costs, plus a fixed rate of return on their investment. This "rate of return" regulation lacks the efficiency incentives that alternative regulation, such as price caps, could provide. Under the current system, the only means by which a carrier earning at its authorized rate of return could increase its earnings would be

to increase its investment base. Likewise, a carrier earning at its authorized rate of return would be forced to reduce some rates of existing services to introduce a new or innovative service which required little or no new investment. This type of constraint holds out no marketplace incentive to a carrier to accelerate the introduction of promising but untested services.

Incentive regulation will not affect the quality or reliability of existing services. Local telephone companies emphasize the quality of their service. It is a fundamental principle embedded in the business. Experience with telephone instrument deregulation illustrates that those companies that have maintained quality in equipment and service have been most successful. Local companies understand that allowing quality to decline is bad business. Lower quality service increases expenses and decreases call completion rates. The bottom line suffers because revenues don't go up, and expenses don't go down. Finally, state and federal regulators would continue to have the same degree of authority under incentive regulations to address issues related to service quality.

The final benefit for the consumer arises in the area of rates. Historically, the inflationary increase in local telephone service have been 2% lower than the nationwide inflation rate.

The FCC has proposed that local telephone service rates would be expected to do *better* under incentive regulation—beating the change in the nationwide inflation rate by *3%*, a full 50% more than the historical track record. Thus, the consumer would be *guaranteed* a savings *greater* than what had been achieved under rate of return regulation. In fact, the proposed upfront commitment to reflect productivity gains in rate would *assure* that consumers benefit from incentive regulation, because the mechanism for incentive regulation assures there will be savings, regardless of the actual productivity gains achieved in the future.

All local customers would share in the benefits, since the rate bands that would be used for individual service categories would have limits. These limits would require the benefits of incentive regulation be spread among all customers groups. One group of customers will not suffer rate increases so that another group will pay significantly lower rates. Any attempt to move rates beyond the rate bond would trigger extensive regulatory scrutiny.

The "incentives" in incentive regulation must work for a local telephone company to support change, however. An alternative to rate of return regulation that gives all rewards to the consumer will not achieve the desired efficiency incentives. Excessive efficiency expectations will generate their own unique risks or problems.

Carriers can benefit from incentive regulation if they can increase their operating efficiency beyond the expectations built into the new regulatory mechanism. This is possible under the FCC's proposal, but will not be easy. Certainly, productivity gains that consistently beat the assumptions of incentive regulation are not guaranteed.

Although the price cap proposal has drawn support from most local telephone companies, particularly the larger ones, USTA has recognized that incentive regulation may not be appropriate for all local telephone companies. Most small companies participate in average schedule arrangements and the nationwide interstate pools, which would spread both the benefits and the incentives of these alternative regulatory mechanisms, diluting their impact. Thus, USTA has supported incentive regulation that would include an option *not* to participate for smaller companies. These companies would know if their smaller size offers any room to increase efficiency further. These firms would not cause any significant adverse impact on an incentive regulation mechanism, because the twelve largest local telephone company organizations alone provide over 93% of the nation's local access lines. It is also likely that many of the companies that are smaller than these might opt for whatever form of incentive regulation is put in place, if it were balanced reasonably well.

Incentive regulatory proposals that have been addressed to date would pose no threat to the regulatory safeguards that now protect the customer in rural and high cost areas. Thus, the FCC has called for the continuation of its high cost fund as currently targeted, the unitary rate of return, and nationwide average toll rates. These policies help to ensure the survival of small companies, and stable rates for the customers they serve. USTA will continue to encourage the adoption of an alternative to rate of return regulation that can better serve the public interest. The challenge for the FCC is to balance properly the incentive benefits for carriers and the efficiency benefits for customers.

USTA encourages the Congress to permit the FCC to proceed in carrying out the responsibilities entrusted to it by the Communications Act. The FCC has been careful and thorough in moving forward, doing what is expected of an administrative agency with recognized expertise. Affected interests will continue to participate in further FCC activities in this area so that the final product will maximize the over-

all benefits available. There is no reason to demand that the FCC cease activities or retarget its work. Instead, the Congress should encourage the FCC to move ahead, assisting our telecommunications carriers to help propel this nation into the next century.

STATEMENT OF GENERAL DATACOMM INDUSTRIES, INC.

The Chairman's February 17 supplemental response to the House Subcommittee on Telecommunications and Finance ("Supplemental Response") significantly changes the basket/banding approach proposed by the FCC's *Further Notice of Proposed Rulemaking*, 3 FCC Rcd. 3195 (released May 23, 1988) ("*FNPR*"). In combination, these changes will have the effect of giving carriers subject to price cap regulation virtually unlimited pricing flexibility. A clear example of the dangers of the proposed new approach is the impact it would have on ATA&T's ability to manipulate the rates which it charges for individual Dataphone Digital Services ("DDS"), as discussed below.

I. BACKGROUND

The *FNPR* proposed a two-basket approach involving the application of two composite price caps. For AT&T, one basket was to comprise private line services and the other, switched services. For local exchange carriers, the baskets were to include switched services and "all other" services. (*See* 3 FCC Rcd. at 3353-54.) One of the principal criticisms of the *FNPR*'s Price Cap proposal, as reflected in the comments filed with the Commission, was that the proposed baskets were too highly aggregated.

The *FNPR* also proposed a five-percent revenue-weighed price bank around individual rate elements, within which a particular rate could be raised or lowered in any year and still be entitled to streamlined tariff review. A(*See* 3 FCC Rcd. at 3355, 3509, 3515.) The banding requirement was intended to limit the flexibility of carriers to raise or lower the prices of individual rate elements within the highly aggregated service baskefs. As the Commission explained in the *FNPR*:

We see merit in those comments that warn of the danger of wholly unconstrained cost-shifting that would be possible under a broad aggregate approach. We share the concerns . . . that a large degree of aggregation would permit a carrier to make frequent and excessive rate changes. We believe tghat the rate churn and rate instability generated by such practices could severely undermine our goal of maximizing consumer welfare. We therefore propose to add *individual rate element bands* as additional protections.

3 FCC Rcd. at 3355 (citations omitted) (emphasis added).

Despite these concerns, the Supplemental Response (at page 13) proposes a significant change in the composition of the baskets. More importantly, it proposes the elimination of the five-percent band applicable to individual rate elements, and proposes to replace it with a much more highly aggregated—and far less effective—banding approach. In particular, the Supplemental Response recommends that the baskets applicable to AT&T be changed to include the following: residential and small business services; 800 Service; and business services. The business service basket would include seven "service categories": Pro America I, II and III; WATS; Megacom; SDM; other switched; voice grade private line and below; and other private line (*see* page 26). In addition, the Supplemental Response reaches the conclusion (at page 13)—without elaboration—that "rate element banding is not required to protect customers," and that the bands should apply, instead, to the broader service categories within each basket (with the exception of residential service). This new basket/banding approach raises serious ratemaking, competitive and public interest concerns.

II. EXAMPLE: IMPACT ON AT&T'S PRICING FLEXIBILITY IN THE CASE OF DDS

The newly proposed basket for business services would include, as a separate service category, "other private line" (as well as six additional service categories, as noted above). The "other private line" category includes AT&T's DDS offerings. The newly proposed banding approach set forth in the Supplemental Notice would apply to the aggregate "price" for all of the rate elements included within this broad service category, rather than to the individual rate elements themselves (which, as noted above, was the approach originally proposed by the *FNPR*). This means that AT&T could raise or lower the rates for individual DDS rate or service elements by virtually any amount, subject only to streamlined tariff review, so long as the over-

all increase in the revenue-weighted price for the "other private line" service category as a whole stayed below the five-percent upper limit.[1] Thus, AT&T could substantially lower the rates for its lower-speed DDS offerings (*e.g.*, 2.4, 4.8 or 9.6 Kbps), and substantially raise the rates for its high-speed 56 Kbps DDS offering or other highspeed digital services (*e.g.*, 1.544 Mbps), so long as the revenue-weighted price change for the overall service category did not exceed five percent. The result would be a radical departure from cost-based pricing, which the Commission has concluded results in the efficient use of the network. As will be discussed, this newly proposed approach could also have an adverse impact on competition in the market for CPE, since it would enable AT&T—which is also an equipment manufacturer—to manipulate the demand for such equipment to its unfair, anticompetitive advantage.

Anyone familiar with the history of AT&T's DDS tariffs will recall that for an extended period, the carrier consistently employed an unlawful rate structure pursuant to which it substantially overcharged for higher-speed DDS services (*i.e.*, 56 Kbps) and undercharged for lower-speed DDS services (*i.e.*, 2.4 Kbps). *See American Telephone & Telegraph Co.*, 62 F.C.C.2d 774, 792-93, *recon. denied*, 64 F.C.C.2d 994, 1000-01 (1977), *appeal dismissed, American Telephone & Telegraph Co. v. FCC*, 602 F. 2d 401 (D.C. Cir. 1979) (Docket No. 20288); *GTE Telenet Communications Corp. v. American Telephone & Telegraph Co.*, File No. E-81-32, Mimeo No. 4755 (released May 29, 1986) (vacated pursuant to settlement). (Relevant excerpts from these decisions are attached.) The rate structure which the Commission found to be unlawful was pernicious not only because it imposed excessive charges on users of higher-speed services), but also because it had an anticompetitive impact on independent manufacturers of multiplexers and digital data sets.[2] If the newly proposed basket/banding approach were adopted, nothing would prevent AT&T from reverting to the same DDS rate structure which the Commission found to be unlawful in Docket No. 20288, and thereby skew market demand for DDS CPE in favor of its own equipment.

For example, multiplexers can be—and are—used very efficiently in conjunction with higher-speed DDS services, but these services must be priced according to cost in order for their natural efficiencies to be enjoyed by consumers. Otherwise, customers will be forced to purchase bundles of lower-speed offerings to meet their service needs (which would not require the use of customer-premises multiplexers). Concomitantly, if lower-speed DDS services are priced below cost and artificial incentives are thereby created for voice-grade customers to switch to DDS, market demand for modems can also be manipulated to the competitive disadvantage of independent manufacturers.[3] If AT&T has the flexibility to deviate substantially from the cost of providing DDS and other digital services, it will be able to plan its equipment development efforts in accordance with service pricing strategies known only to it and, at the same time, seriously disrupt competing equipment manufacturers' planning and development efforts.

Independent equipment manufacturers adversely affected by AT&T's price manipulation would find it virtually impossible to challenge the rates under the Commission's streamlined tariff review or complaint procedures and, in any event, could be irreversibly harmed before a complaint proceeding could be completed. Thus, although the *FNPR*'s basket/banding approach is not without its problems (as amply demonstrated in the comments filed with the Commission), the approach set forth in the Supplemental Response is cause for even greater concern. The new approach would allow carriers to set prices that bear no relationship to the costs of providing service, and would effectively permit them to ignore their "full and fair competition" obligations as carriers. *See* F.C.C.2d at 798-99.

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[1] The Supplemental Response indicates (at p. 28) that the price band constraint applicable to rate reductions may be eliminated. If that occurs, there could be a significant impact on how the Actual Price Index ("API") is measured and, accordingly, how compliance with the Price Cap Index is evaluated. This is because the API "no-credit" zone proposed by the *FNPR* evidently would no longer apply. The net result would be that substantial reductions in the prices of some services could be used to offset substantial price increases for others, and thus reduce the effectiveness of the Price Cap itself. *See* 3 FCC Rcd. at 3355 & n.628.

[2] The concerns raised by the new banding proposal are similar in many respects to those raised by the "strategic pricing" of special access services by the Bell Operating Companies, which has been the subject of a Commission Investigation for several years (CC Docket No. 85-166).

[3] Of course, the high degree of pricing flexibility afforded by the newly proposed basket/banding approach poses similar competitive concerns for enhanced service providers and interexchange carriers.

III. SPECIFIC QUESTIONS RAISED BY THE NEWLY PROPOSED BASKET/BANDING APPROACH

The Supplemental Response raises a number of substantive and procedural questions that should be considered by the Commission before the Price Cap/"Incentive Regulation" Proposal comes to a vote.

First, the newly proposed basket/banding approach is substantially different from that set forth in *FNPR* and, indeed, appears to ignore the significant price manipulation concerns articulated by the Commission in the *FNPR*. As a consequence, the new proposal cannot be adopted without notice and an opportunity for public comment consistent with the requirements of the Administrative Procedures Act. Moreover, as a matter of fundamental fairness and due process, this new proposal, which is a key element of the Price Cap plan, should be the subject of a further notice of proposed rulemaking before it is seriously considered.

With regard to the merits of the newly proposed basket/banding approach, the DDS example raises a number of issues that warrant careful consideration by the Commission. The fundamental question that must be addressed is: How can the Commission justify a basket/banding approach which would authorize AT&T (and other carriers) to implement a rate structure which the Commission has rightfully concluded is unlawful (*i.e.*, one in which higher-speed DDS rates are inflated in order to subsidize underpriced, lower-speed DDS offerings)?

A related question is how the effects of such a Price Cap regime could be deemed consistent with the Commission's oft-stated objectives of promoting network efficiency (since price manipulation could skew market demand for the various DDS speeds); maximizing consumer welfare by assuring reasonable and non-discriminatory rates (since users of the various DDS services would be alternatively overcharged or undercharged); and ensuring that carriers subject to Price Cap/"Incentive Regulation" adhere to their obligations to engage in "full and fair competition."

With respect to the last-mentioned objective, it is imperative that AT&T's less-than-distinguished record in implementing a lawful DDS tariff not be forgotten, lest history be allowed to repeat itself under a Price Cap scheme. In particular, the Commission should not lose sight of the fact that the newly proposed basket/banding approach would enable AT&T to manipulate the prices of its DDS offerings and thereby manipulate market demand for multiplexers and similar DDS CPE (different types of which are used with DDS services of different speeds) so as to favor its own equipment, with anticompetitive results. Under the newly proposed approach, there would be no effective regulatory safeguards to protect independent manufacturers of DDS-related CPE from AT&T's anticompetitive pricing tactics. Nor could market forces be relied upon, since competition in the provision of DDS-type offerings is minimal, and wholly inadequate to severe as an effective pricing constraint. (Indeed, the rates charged for the few competitive alternatives that exist for DDS would no doubt simply track AT&T's DDS rate structure.)

For all of these reasons, the Commission should decline to adopt the newly proposed basket/banding approach.

THE PROBLEM WITH PRICE CAPS

ADVERSE IMPACT ON EQUIPMENT MANUFACTURERS

Introduction

By letters dated February 13 and 17, 1989, FCC Chairman Dennis Patrick responded to certain inquiries of key congressional leaders concerning his latest proposal for replacing traditional, rate-of-return regulation with a "price cap" regulatory regime. Apparently, the price cap proposal described in the information provided to Congress with these letters is what the FCC Chairman will recommend for adoption by the Commission at its scheduled March 16, 1989, open meeting.

The Price Cap Proposal - General

As we understand it, the FCC Chairman's current price cap proposal would initially apply only to AT&T (which the FCC acknowledges retains considerable dominance) and would be mandatory. Application of price caps to Local Exchange Carriers (LECs) will supposedly be considered in a futher rulemaking. AT&T's existing services will be placed in three "baskets" with a Price Cap Index (PCI) for each basket. The PCI would be initially developed for each basket based on current rates for the services contained therein and would be subject to annual adjustment based on changes in the Gross National Product Price Index (GNP-PI) adjusted for exogenous changes less a 2.5% productivity factor, less a 0.5% Consumer Productivity Dividend (CPD).

The services within each basket would be grouped into "categories" with an upper "band" (the Chairman apparently will recommend elimination of a lower band) set for each category

limiting the extent to which the collective rates for the services within a category are allowed to be increased within a given year without further FCC intervention. The banding would limit such increases to 5% per year, per category for business services. Changes in rates for specific services within the banding limitation for each category would also be subject to maintaining conformance with the Price Cap Index set for the basket. Increases or decreases in the rates of individual services within a category which maintained the 5% upper banding limit for the category, would be considered "presumptively lawful" and allowed to go into effect on 14 days notice. Tariff rate increases which would cause the 5% banding limitation for a category to be exceeded would be subject to a 45 day notice period and perhaps a 5 month suspension and FCC investigation . For those tariff rates considered presumptively lawful, the burden of proving them otherwise would be on the party challenging their lawfulness. For proposed tariff rate changes which would cause the 5% banding limitation for a service category to be exceeded, AT&T would bear the burden of substantiating lawfulness.

Price Cap Structure

There would be three price cap "baskets". The first would cover Residential and Small Business services. It would be divided into six narrow service categories with an upper limit of 5% on increases in the composite of the rates within a service category per year. In addition, there would also be a 2% upward limitation on the annual change in the average residential rate in relation to the Price Cap Index for the residential basket as a whole.

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The second basket would be for 800 Service. The Chairman believes that 800 services, while primiarily for business users, are subject to far less competition than other business services offered by AT&T. Therefore, a separate price cap basket is proposed to be established for such services. The 800 services basket would be divided into four service categories with a 5 % upper band on each category for rate increases within any given year.

The third basket, and the one of most concern here, would be for Business Services. The FCC Chairman presently proposes that the business services basket be divided into seven service categories covering switched, switched private line, and transport private line services. The service categories are as follows: 1) Pro-America I, II, and III; 2) WATS; 3) Megacom; 4) SDN; 5) other switched; 6) Voice Grade Private Line and below; and 7) other private line. A 5 % upper band limit would apply to rate increases per service category in any given year (which purportedly "should also address concerns about strategic pricing and controlled migration of customers").

Domestic Manufacturers Have Been Forgotten
The Danger of Price Caps to Manufacturers Competing With AT&T

In developing his price cap regulatory scheme for AT&T, the FCC Chairman has apparently lost sight of the potentially significant adverse effects that implementation of his recommended plan would have on CPE manufacturers--particularly data communications equipment manufacturers--who design and produce equipment for connection and use with AT&T's regulated services. As both the dominant U.S. provider of essential interexchange telecommunications services and, through its manufacturing affiliate, a major

supplier of CPE utilized with those services, AT&T can materially affect competition in the CPE market. Any regulatory scheme which allows AT&T "more flexiblity" in regard to its provision of services, must, by its very nature, be deregulatory. Because of the critical interdependence between data communications equipment and AT&T-provided services, the lessening of regulation of AT&T's provision of services, particularly considering its dominance, gives AT&T still greater unfair competitive advantages in regard to its provision of CPE.

The FCC and Congress must focus on the adverse impact that implementation of price cap regulation may have on the domestic equipment manufacturers which compete with AT&T. Domestic manufacturers of data communciations equipment make up a segment of the telecommunications industry which continues to maintain a positive balance of trade. These companies must have a domestic base on which to build if they are to continue their penetration of foreign markets for data communications equipment. That domestic base is dependent on two factors. First and foremost there must be a U.S. market providing fair opportunities for these companies to compete with AT&T and others in the provision of CPE. The second essential factor is the continued availability of regulated transmission services within the U.S. at rates which have a reasonable relationship to the underlying costs for provision of such services. AT&T is the dominant provider of interexchange telecommunications services, and AT&T has its own telecommunications and CPE manufacturing company. Therefore, allowing AT&T unwarranted regulatory flexibility to depart from reasonable, cost-based rates for its essential transmission services, provide it with further incentives

and opportunity to act in ways that favor its affiliated manufacturing company to the detriment of other American manufacturers.

Transport Services Have Experienced Higher Productivity Gains Than Switched Services

The Chairman's present recommendations also fail to recognize the significant differences in productivity gains that have occurred, are occurring, and can be expected to continue concerning transparent transmission (transport) services as opposed to those relating to switched and switched private line telecommunications services (this is discussed in more detail in the attached paper entitled "The Declining Cost of Providing Telecommunications Transmission Services").

It should be noted that approximately one-half of the transmission facilities in AT&T's network are utilized for the provision of private line services. As the attached paper shows, these are the services that have seen and will continue to see the greatest productivity gains through the use of fiber optic technology. Conversely, switched services which utilize switching and associated equipment at AT&T offices will experience relatively lower gains in productivity. Therefore, combining switched services with pure transport services, as the Chairmans' latest recommendation would do, would mask high productivity gains for transport services with the lower productivity gains expected for equipment used in the provision of switched services. This will prevent these higher productivity gains from being passed on to the users of these transport services. Therefore, if implemented, the price cap regulatory regime must establish separate baskets for switched and transparent transport services.

AT&T's Terrestrial Private Line Services* Are Not Subject to Significant Competition

It is important to consider not only productivity differences in regard to private line transport versus switched network services but competitive differences as well. The marketing trust of the larger of AT&T's services competitors (i.e., MCI, U.S. Sprint) is primarily directed to switched telephone-type services, both residential and business. While these carriers hold out the offering of private line services similar to those offered by AT&T, this has not been the main emphasis of their businesses. Neither of these companies nor the other national or regional interexchange carriers have manufacturing affiliates as does AT&T. Therefore, to the extent these companies compete with AT&T, such competition regards only the provision of services. Unless the price cap plan is properly structured and enforced, it will provide AT&T with the ability to "skew" the rates for its various private line services to favor specific equipment offerings to its manufacturing arm. Since these other interexchange carriers only compete for services, any rate skewing by AT&T will merely be imitated by these other carriers so as to maintain rates for their comparable services at levels similar to those of AT&T.

Chairman Patrick's latest recommendations for "price cap" regulation are in part predicated on the erroneous belief that competition for the telecommunication services of large business

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* The AT&T-provided private line services that are of particular concern to providers of data or integrated data/voice private user networks are terrestrial private line services. These are primarily Analog Voice Grade, Digital Dataphone Service (DDS), and Accunet T1.5 service (1.544 Mbps). It is largely in regard to the equipment which is connected to and used with such services that domestic data equipment manufacturers must compete with AT&T's affiliated manufacturer.

users is greater than for other services. This certainly is not the case in regard to terrestrial private line transmission services. The provision of such services is still dominated by AT&T which has a share of this market still estimated at approaching 95%.

AT&T's Pricing of Private Line Services Affects CPE Market Demand

By lumping all so-called business services--both switched and private line--into one basket, the FCC is providing AT&T with the ability to engage in "strategic" pricing between various private line service offerings within a service category. The pricing flexibility provided by combining switched and private line services in one price cap basket and then aggregating private line services into a category within that basket, provides AT&T with the ability to price these services so as to affect the market for CPE used with such services. AT&T can cause migration of customers from one private line service to another, and thereby affect CPE sales, by manipulating the prices of its private line services.

It is also important to note that private line services must continue to have a reasonable relationship with the underlying cost of providing such services, because different CPE is used with different services. For instance, if AT&T prices its T1-type services too high, it will discourage the purchase and use of multiplexing and related equipment with those services. This would also cause customers to utilize individual, lower capacity services such as those provided under AT&T's Dataphone Digital Service (DDS) tariff. As CPE used with 1.544 Mbps services is different than that used to connect to 56 Kbps DDS services, which is different from that used with Subrate (2.4, 4.8, and 9.6 Kbps) DDS services,

AT&T can directly affect the sales of such competitive CPE based on how it prices these services in relation to one another. If AT&T is not required to price its private line services so as to reflect actual costs, and if AT&T is not properly regulated in this regard, equipment manufacturers will not have the necessary factual economic information on which to base their equipment research and development decisions*, and users will not have the real economic facts that they need to make correct decisions as to which combination of services and equipment to buy.

Essential Corrections to Proposed Price Cap Scheme

While serious reservations remain concerning the implementation of a price cap scheme of regulation, if such a plan is to be implemented, at least the following changes must be made in its structure. AT&T's switched and private line services for its business customers must be placed in different "baskets". All of the switched telephone and switched private line services should be placed in a separate basket with service categories as appropriate within that basket.

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* AT&T's manipulation of rates for its various private line services can be particularly pernicious in its affect on product development activities of equipment manufacturers. In the data communications equipment market, life cycles for products are becoming shorter (three to four years) whereas development cycles are becoming more protracted (from one to two years, with even longer periods for complex products). A company could allocate a portion of its limited R&D resources to commence development of a product based on AT&T's private line tariff rates at that time. After a year of development work by the company, AT&T "adjusts" its rates making the product under development no longer viable. The company then stops development of the first product and commences development of a different product that has an apparent market based on AT&T's revised private line rates. A year later AT&T again manipulates its rates and the entire process repeats. The net result is that the manufacturing company continues to spend its limited development resources without ever being able to bring a viable product to market.

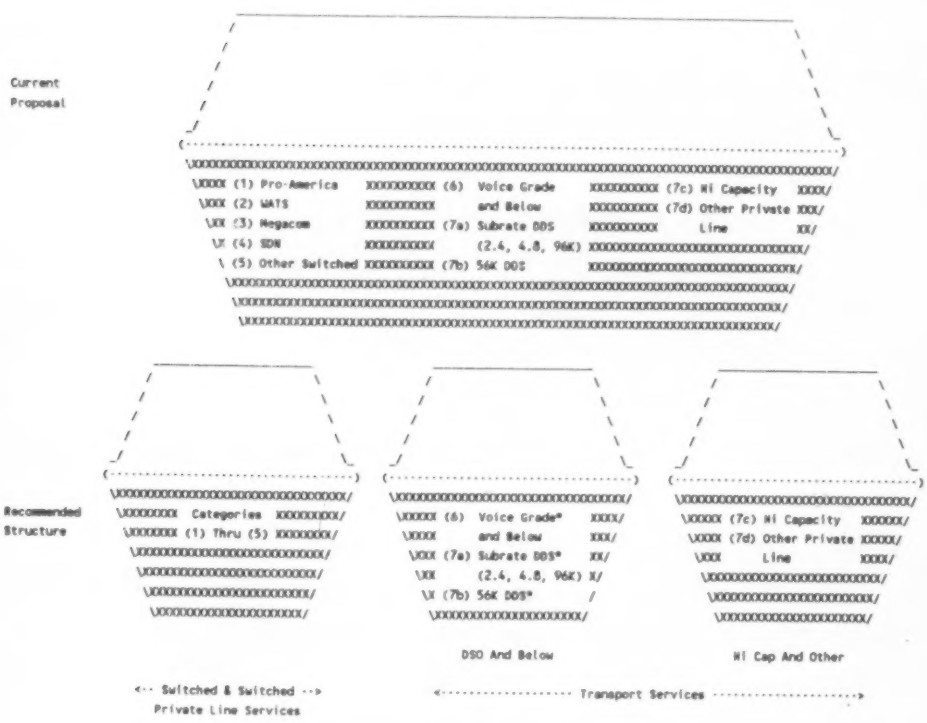
A fourth and fifth basket should be established for transparent transport, private line services. The first of these being transport private line services of DSO capacity and below. There should be three service categories within this basket as follows: 1) Analog Voice Grade and below, 2) Subrate (2.4, 4.8, and 9.6 Kbps) DDS services; and 3) 56 Kbps DDS services. The fifth basket should contain separate service categories for 1) High Capacity Transport services comprised of 1.544 Mbps (T1), 44.736 Mbps (T3), and, looking forward, so-called "Fractional" T1 (FT1) services (i.e., 1/4 and 1/2 of T1 service capacity of the type presently offered under AT&T's international tariff and expected to be offered soon domestically) and 2) Other Private Line services (see diagram).

To further limit AT&T's ability to manipulate its rates to harm both ratepayers and CPE competition, the "banding" for service categories should be narrower. The upper band limit should be reduced from 5% to 2%.

As the enclosed paper on declining costs substantiates, the productivity factor to be applied to the private line transport baskets should be increased. Cost savings through implementation of fiber optics should be recognized in the applied productivity factor to assure that the users of these transport services share in the benefits.

This recommended makeup of baskets for private line services would more closely align the services in a basket with the type of CPE utilized with those services, would better align the baskets and categories with respect to realized and expected productivity,

and would mitigate against AT&T using the flexibility given it under a price cap regulatory scheme to further adversely affect the market for competitive data communications equipment CPE.



BUSINESS SERVICES "BASKET"
NECESSARY MODIFICATIONS IN STRUCTURE:

1) Separate Switched/Switched Private Line Services From Private Line Transport Services
2) Establish Baskets/Categories Comprising Comparable Transport Services

*The relationships between these services were at issue in the DDS rate case (FCC Docket 20288).

THE DECLINING COST OF PROVIDING TELECOMMUNICATIONS TRANSMISSION SERVICES

The Federal Communications Commission is currently considering a proposal to implement a "price control" regulatory scheme for dominant telecommunications carriers. This so-called "Price Cap" regulation would replace the historic, rate-of-return regulation which applies to telecommunications services provided by dominant carriers today.

The costs of providing telecommunications transmission services have and will continue to significantly decrease. Interexchange carriers are installing fiber optic cables and advanced optical electronics at a significant pace. This is the main focus of this paper.

Fiber has also been installed for interoffice facility applications at the local level and the fiber cost model presented here would generally apply to these applications. However, fiber has not as yet been extensively deployed in local distribution plant and the exact timing for its implementation for local customers' loops is somewhat uncertain.

The utilization of high capacity fiber optics with the cost for both the cable and its installation declining; the relatively low cost of the optical electronics used with fiber optic cables, which also has seen significant reductions in cost coupled with tremendous increases in capacities/capabilities; along with the increasing utilization of other digital facilities and equipment, has all contributed to large reductions in the costs for provision

of telecommunications transmission services--particularly inter-exchange telecommunications transmission services.

The enclosed materials include and explain the development of a fiber optic transmission model and contrast the costs associated with that model with the charges for analog voice grade telecommunications services at existing tariffed rates. These comparative calculations show that if the rates for analog voice grade services were based on the costs developed for the fiber model, a ten-fold reduction in the rates currently charged for these services would be justified--this would represent savings of billions of dollars annually for the users of those services.

The materials show that the costs for provision of telecommunications services are already declining based on the fiber model and will, going forward, continue to reduce. Therefore, implementation of a Price Cap regulatory scheme should be deferred until these significant cost reductions are fully and adequately recognized. Price Cap regulation should not be implemented on the basis of rates which were developed using high, historical costs which are no longer representative of the lower costs being incurred today (e.g., must be based on costs of the technology presently utilized and being implemented). At the very least, any Price Cap regulatory regimen must ensure that all achieved cost reductions are fully taken into account in establishing the initial "Price Cap" rates. To do otherwise would mean that the ratepaying public would be burdened with much higher telecommunications services rates than current costs for providing such services would justify.

UNITED STATES SENATE

COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION

SUBCOMMITTEE ON COMMUNICATIONS

STATEMENT OF LAWRENCE GARFINKEL

MARCH 1, 1989

My name is Lawrence Garfinkel. I am a Vice President of American Telephone and Telegraph Company. AT&T is submitting this statement in support of the Federal Communications Commission's plan to replace rate of return regulation of AT&T with a system of price caps and a streamlining of the regulatory procedures. AT&T believes that regulatory reform is long overdue to reflect the competitive nature of the interexchange telecommunications industry.

Over 20 years ago, the Commission first concluded that competition in the interexchange market was in the public interest. Over five years ago, the Commission ended its active tariff regulation of AT&T's competitors, leaving AT&T the only interexchange carrier subject to an unequal regulatory process. It has been over five year since A&T divested itself of all but its competitive businesses. The monopoly for which rate of return regulation may have been appropriate disappeared years ago for AT&T. The competitive interexchange market permits, indeed compels, the Commission to take the next step for AT&T.

The long distance market is now served by more than 500 competitive carriers, with no fewer than 12 carriers competing in any state and several larger facility-based carriers competing almost everywhere. As the most recent FCC Reports indicate, competition has driven AT&T's market share down nearly 20 percentage points, from 85 percent in mid-1984 to approximately 68 percent today. Indeed, in the highly contested outward domestic business market, AT&T's share is down 25 percentage points from where it stood just four years ago. Moreover, MCI, Sprint and AT&T each have sufficient raw capacity to carry the entire nation's long distance telecommunications demand that exists today. In addition, other carriers such as NTN, WilTel/LightNet, SouthernNet/Teleconnect, and others add substantial alternative capacity and choice. This intense level of competition drives prices toward costs, and prevents AT&T from raising prices above market-driven rates.

The competitors are doing very well. MCI has been experiencing explosive growth in revenues and earnings. According to public reports, in 1988 alone, MCI's earnings rose more than five-fold and its revenues increased 30.4 percent to $5.14 billion. This growth follows remarkable performance in 1987, when MCI tripled its profits and had back-to-back billion-dollar revenue quarters. Moreover, MCI itself predicts that its currently strong market share of 11 percent will increase within the next five years to a 20 to 30 percent share, producing potential annual revenues in excess of $20 billion. Sprint, too,

is doing well, making especially strong inroads with regard to large corporate and government accounts. For example, US Sprint recently was awarded 40 percent of the federal government's FTS2000 contract, to rebuild, maintain and operate the federal government's telephone system as a state-of-the-art network. It has been reported that this project alone will increase by 10 percent US Sprint's current annual revenues of more than $3 billion. As a recently released Ernst and Whinney study also reports, long distance firms other than the largest three long distance companies (AT&T, MCI and US Sprint), had 8 percent market share, experienced 25 percent growth in gross revenue and had a 31 percent jump in minutes of use in 1988.

Rational regulation must reflect the dynamics of the competitive market. Having been relieved of both direct earnings and price regulation, AT&T's competitors compete freely and successfully. Yet, when AT&T attempts to introduce new services and lower rates, AT&T's competitors use the regulatory process to delay those offerings and thereby gain a competitive advantage. To bring all the benefits of full and fair competition to consumers, the Commission must allow AT&T to compete on an equal basis with its competitors.

As a transition to the same regulatory scheme governing our competitors, AT&T supports the Commission's effort to replace rate of return regulation with price caps and urges that this be done immediately.

The FCC's proceeding was started almost two years ago. There have been at least three full cycles of pleadings containing detailed materials and evidence as to the benefits of price cap regulation. The record is one of the most extensive in the FCC's history.

In the first round, which concluded over one year ago, over 5,000 pages were submitted from over 70 parties. The FCC then asked for detailed rules to be submitted on which over 1,000 pages of comments were received. Additionally, the Commission issued a further notice in May 1988 specifying a detailed proposal on which 5000 pages of comments were submitted. These materials discussed in detail the benefits of price cap regulation and detailed steps as to the specifics contained in the Commission's proposal. There is simply no reasonable basis to conclude that the Commission does not have an adequate record on which to move forward for AT&T.

The FCC has now apparently incorporated extra protections for consumers in its proposed plan for AT&T, such as a separate basket for residence consumers. It also proposes banding constraints for services within the proposed baskets. Although we do not believe these extra restraints are necessary, it is far more important that regulatory reform not be delayed any longer.

The intense competition in the interexchange market will assure that AT&T's prices will remain cost-based and that AT&T will continue to provide high quality, innovative service. Our

competitors have begun to recognize that quality of service is an attribute that they must strive to achieve. Therefore, whatever the regulatory structure, price caps or not, the competitive market will punish anyone who allows quality to deteriorate and thus assures that AT&T will continue its tradition of outstanding service at just and reasonable rates.

The monopoly model which governed the long distance market disappeared long ago. Competition was selected as the model that would best serve the public interest. Yet, despite the vigorous and effective competition in the long distance market, AT&T is still regulated in stringent monopoly terms just as it was pre-divestiture when AT&T possessed control of local bottleneck facilities. If consumers are to truly benefit from competition, AT&T must not be excluded by regulation from being a viable choice. The FCC should delay no longer in taking the next step to initiate reformed regulation of AT&T and thus bring consumers the benefits of lower prices, quality service, and choice that only full competition can bring.

National Telephone Cooperative Association

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(202) 298-2300

March 7, 1989

The Honorable Daniel K. Inouye
Chairman
Senate Communications Subcommittee
227 Hart Senate Office Building
Washington, D. C. 20510

Dear Chairman Inouye:

On behalf of the National Telephone Cooperative Association (NTCA), I am submitting this letter for inclusion in the record of the March 1, 1989, hearing on the Federal Communications Commission's price cap proposal. NTCA is a national trade association representing 470 small, rural telephone systems operating in over 40 states. From the inception of the price cap proposal, NTCA has been actively involved both at the Federal Communications Commission (FCC) and with Congress. Our interests have been confined to ensuring that the introduction of price-cap regulation does not adversely affect small telephone companies and their subscribers.

NTCA is not opposed to the concept of price caps. However, we insist that inclusion of several provisions in the plan are necessary in order that it not jeopardize the existing mechanisms which have been put in place by the Commission to further universal service goals. We are also concerned that small telephone companies not be required to convert to price cap regulation because its theoretical basis does not apply to small companies in most instances.

We believe that the FCC has made progress in addressing small company concerns. We are encouraged by recent statements of Chairman Patrick indicating that the FCC is striving to recognize NTCA's concerns. Specifically, Chairman Patrick has stated:

(1) Rate of Return

> [P]rice cap regulation should not disturb our long standing practice of employing a unitary rate of return for the local exchange industry, thereby ensuring that access rate determinations for those remaining under rate of return and the support mechanisms associated with the access charge revenue requirements are unaffected by the implementation of a price cap system." (Letter, February 24, 1989 to Chairman Inouye, Small Telephone Company Issues, Attachment E)

(2) Common Line Pool Support Mechanism

"Under the proposal I will recommend, LECs must segregate common line in its own basket...This proposal will not create the kind of LEC pricing flexibility that commenters argue would force AT&T to deaverage its rates." (Id., Attachment E, Geographic Rate Averaging)

(3) Geographic Rate Averaging

"...[A]ny effort AT&T might take to deaverage its rates would have to be done in the context of a public tariff filing...Given the Commission's strong commitment to geographic rate averaging, we would suspend and investigate such a filing. Thus AT&T could not execute deaveraging without the Commission's scrutiny, and the participation of interested parties." (February 17, 1989 letter to Chairman Markey, p. 62)

(4) Price Caps Not Mandatory for Small Companies

" [Price cap] regulation would be mandatory for large, Tier 1 LECs, and optional for smaller LECs." (February 13, 1989 letter to Chairman Markey, Response, p. 1)

On February 23, 1989, NTCA's full membership passed a resolution at its annual meeting insisting that all appropriate means be exercised with the FCC, before Congress and the courts to reach a favorable resolution of the issues important to NTCA in the price-cap proceeding. A copy of that resolution is attached for inclusion in the record.

NTCA recognizes that Chairman Patrick's statements represent progress in addressing small company concerns. We will continue to work with the Commission to ensure that the final rules include the necessary safeguards.

We are also very grateful to members of this Committee for their continuing interest and insistence that universal service protections are maintained and strongly support your efforts in that regard.

We support H.R. 1238 introduced in the House of Representatives by Congressman Cooper and others.

Sincerely,

Michael E. Brunner
Chief Executive Officer

Written Statement of
THE ORGANIZATION FOR THE PROTECTION
AND ADVANCEMENT OF SMALL TELEPHONE COMPANIES

Before the
Subcommittee on Communications
Committee on Commerce, Science, and Transportation
United States Senate

March 15, 1989

The Organization for the Protection and Advancement of Small Telephone Companies (OPASTCO) is a national trade association of more than 380 independently owned and operated telephone companies serving rural areas of the United States. Our members, which include both commercial companies and cooperatives, range in size from less than 100 to nearly 50,000 access lines and together serve more than one million customers.

There are three basic points for the FCC to keep in mind when considering implementation of price caps. These considerations are:

1. That price caps should be optional and not mandatory for small companies and that small telephone companies and large telephone companies have some very basic differences that the FCC must accommodate when issuing an order in this proceeding.

2. That for small companies not choosing price caps, an industry average rate of return be maintained, universal

service fund be protected, the nationwide geographic toll rate averaging be continued, and the NECA pools be maintained.

3. That any order must give small telephone companies a realistic choice of whether to adopt price caps regulation or maintain rate of return regulation.

OPASTCO applauds Congress for its constant monitoring of this proceeding as it has developed. Our members hope that this interest will continue until the FCC's proposal comes to fruition.

Our concerns are warranted because we, as small telephone companies, have been repeatedly assured in the past that we will not be significantly affected by industry changes or regulatory decisions. However, from the divestiture to implementation of the new Uniform System of Accounts, small telephone companies have been affected in profound ways. Repercussions from various decisions have drastically changed the way in which small companies provide service to their customers. For example, one OPASTCO member has found it necessary to have two additional employees, in a total workforce of only fourteen, to handle and digest all of the documents and data requests that were purported as not affecting small telephone companies.

Just as other decisions have dramatically affected the way in which small telephone companies conduct business, price caps will have a significant impact. Our interests are unique and

must be treated as such. Our members cannot be considered as being just like the Bell companies, only smaller. If that scenario is followed, not only small companies, but also their customers will suffer. Many have recognized our uniqueness. Congressman Cooper initiated this acknowledgement by introducing his bill, H.R. 5019, to the 100th Congress.

On January 19, February 13, February 17, and February 24, 1989, Chairman Patrick sent letters to Chairman Dingell, Chairman Markey, and others regarding the FCC's price cap proposal and its implementation. Included in the letters was FCC Chairman Patrick's response to a request for information about the impact of price cap regulation on consumers and on the telecommunications industry, and about protection for small telephone companies. Due to concerns raised by many involved, the Chairman proposed a more detailed description of the Commission's intentions regarding the effects of implementation on small companies.

The Chairman proposed many recommendations in order to alleviate small company concerns. OPASTCO is encouraged by the Chairman's acknowledgement of the inherent differences between the Bell companies and the Independent companies. First, he proposed adjustments to FCC rules that would permit price cap regulation to be applied to LECs whose corporate structure includes both cost and average schedule companies (e.g.

modifications to the "all or nothing" rule). Second, Chairman Patrick suggested that the FCC create adequate opportunities for small carriers to elect price cap regulation and treatment. Finally, the Chairman submitted that the Commission would amend the proposal in the Further Notice to allow certain small LECs to obtain treatment of equal access costs as an exogenous factor. Chairman Patrick also identified the preservation of universal service mechanisms in a price cap environment and the maintenance of the interexchange carriers' ability to geographically average their rates as the two most important issues for small telephone companies.

Protecting and promoting the provision of universal telephone service to all Americans is also a concern to the Commission. Chairman Patrick has made assurances that the price cap proposal will not compromise any of the important programs which promote universal service. Furthermore, Chairman Patrick indicated that price caps "should not disturb our longstanding practice of employing a unitary rate of return for the local exchange industry, thereby ensuring that access rate determinations for those remaining under rate of return and support mechanisms associated with access charge revenue requirements are unaffected by the implementation of the price cap system".

The Chairman also expressed the Commission's commitment to geographic rate averaging as a policy that has proven to be effective in protecting rural ratepayers and customers of high cost LECs from unduly large common line cost recovery burdens. Geographic rate averaging has permitted rural ratepayers to share in the benefits of increased interexchange competition. The Chairman assured that he will recommend that the LECs must segregate common line in its own basket. He suggests that the proposal will not create the kind of LEC flexibility that may force AT&T to deaverage its rates. However, he also said that it is unnecessary for price cap rules to include any specific prohibitions regarding deaveraging.

OPASTCO filed comments and reply comments in the proceeding before the Commission, and maintains the position it expressed in them. Due to the unique characteristics of small, independent telephone companies, OPASTCO recognizes two general sets of issues. One set addresses the concerns of companies which will not elect price cap regulation. The second set represents the interests of small companies which would like to utilize price cap regulation.

OPASTCO urges that price cap regulation should never be mandatory for small telephone companies. To assure the continued viability of small companies which do not elect price cap regulation, the Commission must grant the National Exchange

Carrier Association (NECA) significant regulatory flexibility so that the small companies may effectively coexist with the large companies electing price caps.

A vast majority of small telephone companies will choose to continue participation in the NECA pools or file tariffs under the small company rules. Therefore, the Commission must assure that the provisions of the Unity 1A Agreement adopted by the Commission and the Joint Board are preserved. A single industry rate of return should continue; the Universal Service Fund must remain viable; and, the long-term support mechanisms must be effectively guaranteed. To assure that these provisions are met, specific rules to assure compliance must be incorporated into rules applicable to all companies, including those electing price caps.

The Commission's proposal must give small companies a realistic option to elect price cap regulation. Average schedule companies must have the same options as cost companies with respect to electing price cap regulation. Small companies should be able to transfer directly from NECA pools to price cap regulation if they so desire. By including these provisions in its proposal, the Commission will remove barriers to small company participation in price caps.

Finally, the Commission must continue to modify its

proposal in ways which will remove aspects of price cap regulation which would be particularly onerous for small companies which make the price cap election. A productivity factor in addition to that which is embedded in the price cap formula should not be applied to small companies. The Commission must also recognize that there are reasonable and foreseeable justifications for above-cap rates to be filed by small telephone companies. Therefore, the FCC should not apply the stringent standard for above-cap rates to small telephone companies. A lesser cost justification standard for small company price cap tariff filings could be appropriate. Small companies are called independents for a very good reason, that being because they are not a microcosm of a Bell company. This fact must be acknowledged.

Chairman Patrick's correspondence with Congress indicates that he is taking into account much of what OPASTCO and others recommend. The FCC's price caps plan must not only serve the Bell Operating Companies and their customers, but also serve the people and small telephone companies of rural America. Together, Congress, the Commission, and interested parties can formulate a plan which will be beneficial for all of the players.

Given the assurances outlined by Chairman Patrick, OPASTCO believes that the industry needs implementation of price caps

as long as small companies have the option to remain on the rate of return regulation. In addition, price caps should be implemented for exchange carriers and AT&T at the same time.

OPASTCO plans to continue working with the FCC to implement the following two items outlined in the Chairman's letters:

> 1. To alleviate these small telephone company concerns I will recommend: (1) adjustments to FCC rules that would permit price cap regulation to be applied to LECs whose corporate structure includes both cost and average schedule companies (e.g., modification to the 'all or nothing' rule); (2) the creation of adequate opportunities for small carriers to elect price cap regulation treatment; and (3) amendment of the proposal in the Further Notice to allow certain small LECs to obtain treatment of equal access costs as an exogenous factor.

(Chairman Patrick's January 19, 1989 letter to Chairman Dingell and to Chairman Markey)

> 2. The order also preserves existing protections for small telephone companies and their subscribers, including (1) geographic rate averaging, (2) our policy of prescribing a unitary rate of return for cost companies, (3) the system of common line and traffic sensitive pools administered by the National Exchange Carrier Association (NECA), and (4) the various programs operating in conjunction with common line pooling to assist high cost companies and promote universal service.

(Chairman Patrick's February 13, 1989 letter to Chairman Markey)

OPASTCO believes that if the FCC continues to move forward in addressing the concerns of rural areas and small companies, price caps can work for companies of all sizes and contain protections for small companies.

February 28, 1989

Honorable Daniel K. Inouye
Chairman
Subcommittee on Communications
Committee on Commerce, Science,
Transportation
U.S. Senate
Washington, D.C. 20510

Dear Chairman Inouye:

On behalf of the more than 240 consumer advocacy organizations that make up the Consumer Federation of America (CFA) and the over 700 major corporate, educational, and governmental telecommunications users that comprise the International Communications Association (ICA), we are writing to express our extensive concerns about the price cap data and information contained in the Federal Communications Commission (FCC) Chairman's letters to the Congress dated February 13 and 17, 1989, and in the FCC's price cap computer model which was delivered by the FCC to Congressional staff on February 23, 1989.

INTRODUCTION

Both CFA and ICA testified during Congressional hearings on price caps during the 100th Congress. Both organizations continue to share the concerns they expressed last Congress, because our review of the FCC data and information that is the subject of these comments indicates that the FCC has yet to positively address the concerns of residential and business ratepayers.

ICA's and CFA's review of this most recent data and information on the FCC's price cap plan indicate that the Commission has done virtually nothing to address the shortcomings raised by ratepayers last year during your subcommittee hearings on the FCC's price cap plan and in filings with the FCC in response to its May 1988 Further Notice of Proposed Rulemaking, or to address the concerns raised by Congressman John D. Dingell, Congressman Edward J. Markey, and yourself during the course of the public debate about the FCC's new form of price regulation. Rather than respond to concerns about excessive price discrimination (including raising evening and night/weekend rates), under-measurement of carrier productivity (denying ratepayers the benefits of lower costs), and locking in inflated initial prices under the price cap plan, FCC Chairman Patrick proposes changes that ignore these and other ratepayer problems and that actually make the proposal even worse for ratepayers.

For business users, the FCC Chariman's newest plan is clearly worse than that proposed in the FCC's Further Notice of Proposed Rulemaking last Spring. Then, the FCC proposed to have only two baskets for AT&T, one for switched services and one for private line services. With regards to switched services, business users objected that at a minimum, business and residential switched services should be separated into <u>two</u> separate backets so as to eliminate residential future cross-subsidy concerns. Regarding private line services, business made extensive arguments about the differences and levels of competition between analog and digital services. Since most major long distance providers of private line long distance services are installing <u>only</u> digital circuits, the competition within the digital private line market is growing. But as a result of this growing concentration on <u>all digital</u> networks by the long distance carriers, business users who still depend upon analog private line circuits are finding the they have few alternatives to AT&T's analog private line circuits. With few alternatives for analog private line circuits, business users are understandably concerned about having analog and digital private line services combined within the same basket. AT&T in its public and private statements to the FCC and to business users has agreed to separate baskets for analog and digital private line services. The FCC's total disregard for these facts and business user concerns is inexcusable.

Contrary to the FCC Chairman's assertions, his reformulated price cap proposal would short-change ratepayers $1.5 billion per year even with its consumer productivity dividend, as compared to current rate of return policies. In addition, the FCC Chairman's plan appears to indicate that the FCC is going to allow consumers to bear the burden of AT&T's recent $6.7 billion write-off of equipment. Both CFA and ICA have stressed the need for the FCC to establish that existing rates are just and reasonable before initiating price caps, since most of the rates in effect today for both AT&T and the RBOCs have never been found to be just and reasonable. [Business users have challenged the FCC to establish the justness and reasonableness of many services, particularly the strategically-priced special access services of the RBOCs.]

Also, the FCC price cap proposal would allow AT&T to reduce the evening and night/weekend discount dramatically, as it has attempted to do in recent years, with potential 20% increases of these services over the first four years of the proposed price cap plan. Finally, since the FCC has not properly anticipated AT&T's cost savings and required that they be shared with ratepayers, Chairman Patrick's plan would transform potential long distance reductions into AT&T profits that would have no meaningful restraints.

The details of the FCC Chairman's newest proposal are so clearly anti-user, as compared to current rate of return rules,

that we believe that the Commission must go back to the drawing board in an effort to adequately address consumer and business user concerns before adopting any new form of price cap regulation.

RATEPAYER CONCERNS

1. FCC Productivity Analysis.

The extensive material submitted by Chairman Patrick to your subcommittee demonstrates that his newest price cap proposal does not meet his self-proclaimed goal of developing a plan that is better for ratepayers than the current form of regulation. Rather than generate its own productivity data concerning AT&T, as you and others have proposed, the FCC relies on pseudo-productivity studies, which are really price tracking studies, and dismisses, with little or no explanation, the extensive productivity analysis submitted by users which found AT&T productivity to be approximately 4%. As a result, if all other aspects of the FCC's price cap computer model remained unchanged except an increase of 1% point in the productivity component [the difference between the FCC's 3.0% number (2.5% productivity factor, plus .5% consumer dividend) and the ratepayer productivity projections of 4% (4.0% productivity factor without even adding the FCC's .5% consumer dividend)], the annual benefit to residential customers would be over $1 billion and the total savings for all ratepayers would be over $1.6 billion per year. [See Attachment A.]

2. FCC Common Carrier Bureau's Price Cap Computer Model.

The FCC's computer model is rather simplistic and fails to include any of the adjustments for price elasticity of demand, which was reflected in the AT&T model, or for the actual revenue growth that AT&T used in its computer model. More significantly, the FCC computer model is based only upon total "revenue caps" by service. It does not reflect the revised formulas for the Price Cap Index (PCI), the Actual Price Index (API), or the proposed Service Band Index (SBI) -- all of which the FCC Chairman stated were part of his 2/17/89 proposal. Since the Chairman stated that these formulas actually govern the operation of the price caps plan, the FCC computer model cannot in any sense be said to reflect the true mechanics of his proposed plan. [See Attachment B.]

3. Residential Evening and Night/Weekend Rates.

The continued assertion of the FCC Chairman that consumers would be better off under his proposed price cap plan is most astonishing. It was not until ratepayers had a chance to review the FCC's 2/17/89 letter (p.23) and its computer model that we realized that the basis for the FCC Chairman's comparison was a

anti-consumer rate-of-return scenario over the next four years. By assuming that the FCC (without any prior cost analysis or public proceeding) would reduce evening and night/weekend discounts at a rate of two percent per year over the next four years, the FCC Chairman is able to assert that consumers would be better off under price caps. However, if this one outlandish assumption is eliminated, the residential ratepayer savings (over four years) of $688.55 million or $700 million as touted by the FCC Chairman in his 2/17/89 letter actually changes to a negative residential impact of $400.67 million -- a shift of almost $1.1 billion over four years! [See Attachment B.]

4. Residential Basket.

The FCC Chairman's new "residential and small business" basket does nothing to adequately protect consumers against rate increases for the services they use most - evening and night/weekend long distance calling. Chairman Patrick's plan would allow AT&T to raise these rates five percent per year, reducing the 50 percent night/weekend discount to about 34 percent and/or the evening discount from 35 percent to about 14 percent over four years. The FCC Chairman's special two percent overall price increase limitation for average consumer bills does not alter this potential residential discount erosion. [These residential services are lumped together with daytime, international, and "Reach Out America" callers to dilute the two percent constraint on evening and night/weekend rates.] As a result, the FCC Chairman's plan appears to allow for the virtual elimination of the present evening and night/weekend discounts within the first four years of price caps.

Of course, nothing in the FCC's price cap plan would require AT&T to reduce these discounts. Yet, AT&T's recent behavior demonstrates a clear desire to reduce the evening and night/weekend discounts for residential customers. In its most recent subscriber line charge flow-through tariff filing (involving a 30 cent per month increase in residential telephone bills), AT&T proposed to flow through its savings as a 3.8 percent daytime rate reduction, 0.4 percent evening reduction, and 0.0 percent night/weekend reduction. This is but the latest instance in a three-year AT&T pattern of reducing the differential between daytime and evening-night/weekend.

Also, AT&T's own computer model reveals its intentions under a price cap regime quite clearly. [See Attachment E.] Unless, the FCC requires equal rate reductions for all three services, it is clear that under the FCC Chairman's proposal, AT&T will not maintain the existing discounts for evening and night/weekend calling.

5. AT&T $6.7 Billion Writedown.

In a single sentence on February 1, 1989, the FCC indicated that it will not require AT&T to reduce its rate base for AT&T's recent writedown of $6.7 billion in assets, involving approximately $5.58 billion in regulated network assets. As a consequence, AT&T will not pass on even one penny of the reduction in book value to its consumers. This failure to pass on any or all of these reduced costs conflicts with the notion that AT&T is under significant price pressure from the other long distance service providers.

AT&T appears to have the FCC's blessing to increase its depreciation costs by approximately $1.3 billion per year. As a result, it appears that residential customers could bear about $577 million of this increase and that AT&T residential customer rates would rise by about 6% to pay for AT&T's writedown. Business customers would bear about $472 billion of this increase. [See Attachment D.]

6. Additional Concerns.

Ratepayers have raised concerns about the adequacy of FCC Common Carrier Bureau staff resources. Recent developments regarding the FCC handling of the refunds to ratepayers of excessive charges under the LECs' 1988 annual access tariffs raise questions about the FCC's present ability to acurately monitor carriers under a price cap regime. [See Attachment F.] Also, CFA and ICA are deeply concerned about the FCC's excessive reliance on the "ex parte" process to receive new substantive data and information to develop its price cap proposal. Clearly, this excessive use of the ex parte process denies ratepayers and the industry at large of an opportunity of effectively understanding of what the FCC is doing and of having an opportunity to comment on this data and information.

CONCLUSION

In the aggregate, the apparent deficiencies in FCC Chairman Patrick's most recent price cap proposal could negatively impact ratepayers by at least $ 9 billion over the four year initial phase of the plan. [The total of fours years of productivity

differences ($4-6 billion) and increased depreciation ($5 billion); see Attachments A & D.] This result is so clearly contrary to the FCC's Congressional mandate that we urge you to prevent the FCC from implementing the FCC Chairman's newest proposal.

Respectfully,

Consumer Federation of America

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International Communications Association

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Attachments enclosed.[1/]

1/ The attachments were not reproducible.

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